A THEORY OF FACTS AND CIRCUMSTANCES

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Abstract

The legal consequences of an action often depend on information that only the actor knows, such as her intentions. This information is typically inferred from the observable "facts and circumstances" attending the actor's conduct, which creates a seemingly unresolvable tension in legal design. On the one hand, the unstructured nature of these analyses gives free rein to the factfinder's judgment about which facts justify an inference to the hidden information. On the other hand, if the law specified in advance the facts that would be used to draw that inference it would provide a roadmap for actors to strategically adjust their conduct to manipulate the factfinder's conclusions. I argue that this tension can be resolved by applying insights from the economics literature on asymmetric information. These insights help answer both the substantive question of which facts and circumstances should be taken into account, and the procedural question of whether they should be specified by the legislature or left to the courts. I provide a principle for identifying relevant facts and circumstances and argue that facts and circumstances tests are generally best implemented as "principled standards."

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INTRODUCTION

Legal consequences often turn on things that a factfinder cannot observe, such as an individual's intentions. This is of course true in criminal law, where the actor's state of mind is an element of most crimes,[1] and in contract law and labor law, which incorporate obligations to perform and negotiate in "good faith."[2] But it is also true in areas of the law such as federal income taxation, where there has always been skepticism about assigning tax consequences of the basis of anything other than publicly observable actions.[3] For example, a transfer of money is not a gift unless it is motivated by the "detached and disinterested generosity" of the transferor;[4] the tax consequences of a transaction may be disregarded if the taxpayer does not have a substantial non-tax purpose for entering into the

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[1] RICHARD J. BONNIE, ANNE M. COUGHLIN, JOHN C. JEFFRIES, JR. & PETER W. LOW, CRIMINAL LAW 115-16 (4th ed. 2015) ("for most offenses some requirement of mens rea has existed for centuries.")

[2] See Murphy v. Allstate Ins. Co., 553 P.2d 584, 586 (Cal. 1989) ("This court has observed that '(i)n every contract there is an implied covenant of good faith and fair dealing…"); Continental Insurance Co. v. N.L.R.B., 495 F.2d 44, 48 (2d Circ. 1974 ("parties are obligated to do more than merely go through the formalities of negotiation."); 30 RICHARD A. LORD, *Duty of Good Faith Dealing*, *in* 30 WILLISTON ON CONTRACTS § 77:10, Westlaw (4th ed. 2015); N. PETER LAREAU, *The Obligation to Negotiate a Collective Bargaining Agreement*, *in* 1 LABOR AND EMPLOYMENT LAW § 12.05, Lexis Advance (2017). On the scope of what is within the expectation interest of the parties to a contract, see Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980). On the obligation to bargain in good faith, see 29 U.S.C. § 158(d) (2006) and N.L.R.B. v. Boss Mfg. Co., 118 F.2d 187, 189 (7th Cir. 1941) (good faith means negotiating "with an open and fair mind and sincerely endeavor[ing] to overcome obstacles or difficulties"), all discussed in Samuel W. Buell, *Good Faith and Law Evasion*, 58 UCLA L. REV. 611, 633-634 (2011).

[3] See Edwin S. Cohen, *Tax Avoidance Purpose as a Statutory Text in Tax Legislation*, 9 PROC. ANN. TUL. TAX INST. 229, 257 (1960) ("the tax structure should be satisfied without our seeking to gauge the extent of [the taxpayer's] consciousness in a hazardous effort to probe his state of mind.") See, e.g., Leandra Lederman, *W(h)ither Economic Substance*, 95 IOWA L. REV. 389, 433 (2009) ("tax motivation should make no difference as to whether or not the claimed tax result is upheld.")

[4] Comm'r v. Duberstein, 363 U.S. 278 (1960).

transaction;[5] and expenses are deductible if incurred for the purpose of generating income but not if those expenses are personal in nature.[6] When legal consequences turn on things that cannot be directly observed, factfinders often look to the "facts and circumstances" surrounding the conduct to draw inferences about these unobservable factors.

There is a tension at the heart of facts and circumstances inquiries. On the one hand, the open-ended nature of these analyses mean that their results are uncertain and depend on the factfinder's judgment and experience about which facts tend to be associated with the hidden factor. Factfinders are generally given little guidance about which facts permit a reliable inference to the unobservable factors, and they rarely provide any reasons for selecting the facts that they do. As a result, individuals cannot know in advance all the facts that a judge or jury will regard as relevant or how those facts will be interpreted, and so they have no way of reliably communicating to the factfinder whether they possess the hidden factor on which liability depends. The outcomes of similar cases may provide some guidance, and sometimes the law itself lists facts that must be considered, but these lists are almost always non-exhaustive and the underlying logic for choosing those facts is typically unarticulated.

But on the other hand, trying to specify in advance all the facts that are relevant to inferences about intentions and other hidden factors would create two significant problems. First, facts-and-circumstances tests are generally adopted because the situations across which the law is meant to apply vary widely. In such cases, it is impracticable to identify in advance everything that should give rise to an inference about the hidden factor on which legal liability depends. Second, if the facts that create a favorable inference about a hidden factor are given in advance, it will provide a roadmap for well-

[5] I.R.C. § 7701(o).
[6] I.R.C. §§ 212, 262.

advised individuals to ensure that those facts and circumstances accompany their actions to induce courts to draw the inference the individuals want.

In this Article, I propose a two-part solution to this tension. The first part addresses the substantive question of *which* facts and circumstances should be considered by factfinders. I propose a "screening principle" for choosing the relevant facts and circumstances that places structure on the inquiry and limits the discretion that lawmakers and the courts have to determine which facts to consider. It thereby reduces the possibility that idiosyncratic differences between judges will result in arbitrary differences in case outcomes. Although the principle gives individuals notice about which kinds of facts will be considered by a factfinder, the kinds of facts that are chosen discourage individuals from adopting behaviors that induce courts to draw the wrong inferences. Identifying the principle that should be used in conducting a facts and circumstances inquiry is the first contribution of this Article.

The second part of the solution addresses *when* this screening principle should be used to specify the facts relevant to a facts and circumstances determination. I analyze whether the principle should be used to specify the relevant facts and circumstances *ex ante*, and to make those facts public knowledge by embedding them in the relevant statute or regulations, or whether the principle should be used by courts *ex post*, to interpret conduct after it has occurred. My analysis of this question is economic in nature and applies the framework for choosing between rules and standards provided by Louis Kaplow.[7] Professor Kaplow's foundational analysis of the costs and benefits of rules and standards applies to laws that depend on observable actions, and I show that extending his analysis to laws that depend on intentions and other hidden factors introduces another evaluative

[7] Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 DUKE L. J. 557 (1992).

dimension to the rules/standards choice. In these cases, individuals and lawmakers are playing a "game" in which individuals try and persuade the factfinder about whether they have the hidden factor or not, and the choice between a rule and a standard in this setting is a choice between two different games with potentially different outcomes. I argue that laws that depend on hidden information are often best implemented neither as pure laws nor as pure standards, but instead as "principled standards." This is the second contribution of the Article.

I use Federal Income Tax law to illustrate the tension inherent in facts and circumstances tests and to show how the tension can be resolved using my proposal. Income tax law considers unobservable taxpayer information to be normatively relevant in many contexts and the problem of taxpayer planning in those contexts is especially acute, so it is the ideal setting to test my proposal.[8]

Part I explains why intentions and other hidden taxpayer characteristics play such an important role in tax law, and it describes the issues that courts and the IRS have encountered in making facts and circumstances determinations about that private information in four classic problems in tax law. In Part II, I describe how analyzing these problems within an economic framework requires incorporating richer models of individual decision making from behavioral economics. In Part III, I take up the question of which kinds of facts should be used to draw inferences about hidden and normatively relevant information. This is the question about what the substance of the law should be. I argue that a principle for giving substance to the law emerges naturally from the economics literature on asymmetric information, and I describe how this principle can be applied to help address

[8] For a list of guidance on tax avoidance plans the I.R.S. considers potentially abusive, see INTERNAL REVENUE SERVICE, RECOGNIZED ABUSIVE AND LISTED TRANSACTIONS, https://www.irs.gov/businesses/corporations/listed-transactions (last visited Feb. 20, 2017).

the important tax distinction between business and personal expenses. In Part IV, I address the question of whether laws that depend on private information should be promulgated as rules or standards. I argue that whenever legal consequences depend on private information, the choice between a rule and a standard is also a choice for the lawmaker about whether to play a "screening" game or a "signaling" game with regulated parties. These two games of strategic interaction, although similar in many respects, have different outcomes and a comprehensive analysis of the two must incorporate this consideration. When this additional dimension is taken into account, in many circumstances, facts and circumstances determinations should be implemented as "principled standards," and constraints should be placed on the inferences that judges and juries are permitted to draw.

I. General Statement of the Problem

"Facts and circumstances" inquiries are used to solve a common problem: the legal consequences of an activity depend on the actor's intentions or some other unobservable characteristic they possess, but because the factfinder cannot observe those things it infers them from what it can observe. For example, whether a transfer of property is a gift depends on the intentions of the transferor.[9] How is a factfinder to know what the transferor's intentions were? Courts look to the observable facts and circumstances surrounding the transfer. But which facts should they look to? Which facts permit a valid inference to the transferor's intentions? Courts typically do not say.[10] In *Commissioner v. Duberstein*, the Court

[9] Comm'r v. Duberstein, *supra* note 4.

[10] See Poyner v. Comm'r, 201 F.2d 287, 292 (4th Cir. 1962) ("The Court limited itself to summarizing earlier decisions as to which particular dominant motivations, when

concluded that "[d]ecision of the issue presented in these cases must be based ultimately on the fact-finding tribunal's experience with the mainspring of human conduct to the totality of the facts of each case."[11] Concurring in part and dissenting in part, Justice Frankfurter articulates well one of the primary concerns with such an open-ended approach:

> Varying conceptions regarding the "mainsprings of human conduct" are derived from a variety of experiences or assumptions about the nature of man, and "experience with human affairs," is not only diverse but also often drastically conflicting. What the Court now does sets fact-finding bodies to sail on an illimitable ocean of individual beliefs and experiences. This can hardly fail to invite, if indeed not encourage, too individualized diversities in the administration of the income tax law.[12]

To take another example, consider that expenditures that are incurred "for the production of income" are deductible whereas those expenditures that that are "personal" in nature are not.[13] How do we determine the purposes behind incurring the expense and whether the taxpayer received some personal (i.e., non-pecuniary) benefit as a result? Taxpayers and scholars have been left with Justice Cardozo's memorable, but dispiriting, conclusion that "[o]ne struggles in vain for any verbal formula that will

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adequately supported by the evidence, result in income treatment, and which result in gift treatment. An enumeration of the criteria, by which the trier of fact shall determine in every type of case what that dominant reason is, was deemed inadvisable, if not futile."); Evangelista v. Comm'r, 629 F.2d 1218, 1222 (7th Cir. 1980) ("Eschewing an opportunity to establish an easy to apply test, the Court stated that the determination of whether a transfer is a gift depends on an objective inquiry of all the circumstances.")

[11] Comm'r v. Duberstein, *supra* note 4.

[12] *Id.*

[13] I.R.C. §§ 262, 212 and 162.

supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."[14] My goal in this Article is to show that the struggle need not be in vain.

The problem that taxpayers face in "sail[ing] on the illimitable ocean of individual beliefs and experiences" of factfinders is not just that they get different outcomes depending on how their judge or jury thinks that gift-givers behave, or what sorts of purchases and expenditures generate personal pleasure and which ones don't, but also that forward-looking taxpayers will have an incentive to go out of their way to do things that will persuade those factfinders about their hidden intentions. These efforts to persuade the tax authority about the taxpayer's motivations are socially wasteful, even if they benefit the taxpayer because of the expected tax savings.

For example, suppose that the factfinder believes that gifts always prompt the recipient to write a thank you note, but that transfers that have some other purpose, such as to nurture a commercial relationship, do not. The recipients of true gifts may write a thank you note out of a sense of gratitude, but the recipients of commercial inducements may do so too, merely to ensure that the factfinder believes that they received a "gift." And, recipients of veritable gifts who would ordinarily prefer to express their gratitude in some other way may also switch to note-writing to ensure that they do not have to include the amount of the gift in income.[15] The fact that taxpayers do not know what the factfinder will think is relevant in coming

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[14] Welch v. Helvering, 290 U.S. 111 (1933). Although Justice Cardozo purported to be analyzing the difference between a current and capital business expense and the analysis turned on the question of whether the expense was "ordinary" within the meaning of the statute, the court was also worried about providing a deduction for expenses that are personal in nature.

[15] I.R.C. § 102 (gifts excluded from income).

to a determination about whether the transfer is a gift makes the problem worse. As a result, they may engage in all sorts of peripheral and socially wasteful activities that will make it more likely that they receive the tax treatment that they want. This will be true not just of the person receiving a business inducement, but also the person who receives a genuine gift but cares at least a little about not paying tax on it.

So why not specify, in the applicable statute or regulations, which facts will be used to draw an inference about individuals' private information? One reason, of course is the wide range of circumstances that facts and circumstances tests are meant to address. There may simply be too many facts, that have too different evidentiary values in too many different situations, to specify them all in advance. The second reason not to specify that facts that will be used for inferential purposes is that it provides a strategic advantage to the regulated parties. Once Congress or the Treasury department specify the facts from which fact finders must draw an inference favorable to the taxpayer, then all taxpayers have an incentive to produce those facts, so those taxpayers who do not have the tax-favored characteristic will act as though they do.[16] By giving individuals a roadmap of how to manipulate the factfinder's inference the law would undermine its ability to distinguish between people with the normatively relevant hidden characteristics and those without it.

This is the problem that I address in this Article: how can facts and circumstances tests be structured to both (1) reduce the arbitrariness and unpredictability of determining which facts will be used to draw inferences about the law's applicability, and (2) ensure that factfinders are not manipulated by regulated parties into drawing the wrong inference.

Throughout the rest of the Article, I use examples from federal income

[16] The feedback effect here has something of the issues described in Joshua B. Fischman, *The Circular Logic of Actavis*, 66 AM. U. L. REV. 91 (2016).

tax law to illustrate how insights from the game theory literature can help resolve this problem. But this problem only arises when legal consequences depend on something unobservable, and many scholars argue that tax consequences should turn only on what taxpayers do, not what motivates them. In Subpart A, I describe three categories of tax policy reasons that justify the consideration of intentions in tax law. These reasons derive from tax policy norms that have a great deal of influence over tax policy, but are not necessarily grounded in an underlying normative theory of taxation. However, I then explain how one such normative theory, optimal tax theory, also suggests a role for making taxes dependent on intentions. My goal is to show that there are good reasons to make tax consequences depend on intentions and other private information of the taxpayer so that the reader is convinced of the need for the proposal for facts and circumstances tests that I offer in Parts III and IV. As a descriptive matter, taxes already do depend on intentions and other unobserved individual characteristics, and in Subpart B, I describe four examples where this is the case. I return to these four examples throughout the paper to illustrate the application of my proposal. In Part C, I quickly summarize the problems created by the use of facts and circumstances tests in these examples, focusing on the incentive it creates for taxpayers to misrepresent their intentions to the factfinder.

A. Why Taxes Depend on Private Information

Nearly 50 years ago, Walter Blum observed that "[u]nder our federal income tax many of the substantive rules for classifying actions have long appeared to call for an inquiry into somebody's state of mind,"[17] such as

[17] Walter J. Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI.

their motive, intent or purpose for taking the action.[18] At the time, he found that "[a] broad sampling of cases and administrative pronouncements under our income tax indicates that, as they are expressed, the rules embodying a state of mind test almost always seem to refer to the thoughts of a particular actor."[19] But why are the taxpayer's purposes relevant to the tax treatment of their transactions?

It is common in many areas of the law for legal consequences to depend on intentions. Criminal law, of course, is the most conspicuous example.[20] But the traditional justification for *mens rea* requirements in the criminal context is that criminal laws have moral content and so in order to be blameworthy one must have had a bad mind.[21] But paying taxes is not a punishment and taking an action that results in tax liability is not a crime, not even a regulatory crime.[22] If intentions are not used to assign culpability, then what function do they serve in tax law?

L. REV. 485 (1967).

[18] According to Blum, motive is about the reasons why the action was taken, purpose is what was hoped to be accomplished, and intent is about whether a consequence was within the expectation of the person acting. It matters little, in Blum's view, whether we refer to motive, intent or purpose.

[19] Blum, *supra* note 17 at 499.

[20] See RICHARD J. BONNIE, ANNE M. COUGHLIN, JOHN C. JEFFRIES, JR. & PETER W. LOW, CRIMINAL LAW 115-16 (4th ed. 2015) ("for most offenses some requirement of mens rea has existed for centuries.")

[21] See Jean K. Gilles Phillips & Rebecca E. Woodman, *The Insanity of the Mens Rea Model: Due Process and the Abolition of the Insanity Defense*, 28 PACE L. REV. 455, 463 (2008) ("As far back as the Anglo-Saxon period ending around 1100 A.D., moral liability was entrenched in the criminal law.") Professor Shaviro's view is that the proper aim of anti-tax shelter rules is "not to make ethical judgments about or between tax-motivated transactions, but to minimize overall social harm from deadweight loss." Daniel N. Shaviro, *In Defense of Requiring Back-Flips,* 26 VA TAX REV 815 (2006). On Shaviro's view, tax shelters are not malum in se, instead, "the issue is one of malum prohibitum, or acts that are wrong simply in a compliance sense once they have been identified as legally impermissible or ineffective." *Id.* at 816.

[22] Leavens argues that another justification for mens rea is that it guards against unfair surprise and demands notice. Arthur Leavens, *Beyond Blame-Mens Rea and Regulatory Crime*, 46 U LOUIS. L. REV 1 (2007). For a defense of intent in another non-criminal context, see Ronald A. Cass & Keith N. Hylton, *Antitrust Intent*, 74 S. CAL. L. REV. 657 (2000) (explaining and justifying a role for intent in antitrust law as a way of reducing error costs).

There are at least three reasons that the income tax assigns taxes on the basis of private information, specifically mental states, of the taxpayer: (1) to properly measure income, (2) to limit excessive tax avoidance behavior, and (3) to define a "transaction." These reasons are based on tax policy norms that are widely accepted but that are not necessarily well-grounded in an underlying normative theory of taxation. But there is such a theory that justifies the use of intentions in assigning tax consequences: optimal tax theory. At the end of this subsection, I describe informally a possible role for intentions in optimal tax analysis.

1. Tax Policy Norms

Measurement of Income

The first reason that the tax law incorporates private information of the taxpayer is because the definition of income depends on it. Most tax scholars accept, at least as a starting point, Henry Simons' definition of income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."[23] This definition be pithily summarized as $Y = C + \Delta W$, where Y is income, C is consumption and ΔW is change in wealth. This definition masks a thorny problem. Consider a taxpayer who makes a $100 cash expenditure. If that expenditure purchases "consumption," then the transaction has no effect on income, because the value of the property rights exercised in consumption ($100) is offset by the $100 reduction in the individual's wealth. On the other hand, if the $100 expenditure is incurred not to purchase consumption,

[23] HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY (1938).

but because it is a cost of earning income, then the taxpayer has -$100 in income (a loss) over the relevant period.

Accordingly, a net income tax must distinguish between expenses incurred for the production of income and those that yield consumption. But what is consumption? There is disagreement among tax scholars about the definition of this concept. One view is that consumption involves the withdrawal of resources from the "common pool." A second, broader, view is that consumption is a flow of goods or services that increase the personal satisfaction of the recipient.[24] The difference can be seen in the context of gifts. Suppose that A makes a gift to B, and receives nothing in return except for the good feelings that come from having made B better off. If consumption is equivalent to personal satisfaction then A has neither income nor loss. Under the "common pool" theory, A would have a deductible loss for tax purposes because the personal satisfaction she derives from the transfer does not reduce the amount available to others.[25]

In many cases it can be difficult to know whether an individual has incurred an expense to purchase a consumption benefit or to earn income. How can we distinguish between the two? Henry Simons noted that: "here one finds inescapable the unwelcome criterion of intention. A thoroughly precise and objective distinction is inconceivable. Given items will represent business expense in one instance and merely consumption in another."[26]

Numerous sections of the Internal Revenue Code address the blurry line

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[24] DANIEL T. SLESNICK, CONSUMPTION AND SOCIAL WELFARE: LIVING STANDARDS AND THEIR DISTRIBUTION IN THE UNITED STATES (2001).

[25] There is disagreement among scholars about whether the personal satisfaction that comes from a gift constitutes consumption. Compare Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1 (1992) with William D. Andrews, *Personal Deductions in an Ideal Income Tax,* 86 HARV. L. REV. 309 (1972).

[26] Blum, *supra* note 17 at 543.

between personal and income-producing expenses. These include the deductions for trade or business expenses[27] and expenses incurred for the production of income,[28] the non-deductibility of personal expenses,[29] and rules limiting the deductibility of losses incurred in an activity not engage in for profit,[30] and the compromise treatment of meals and entertainment expenses.[31] In all of these cases, intentions matter because they determine whether the taxpayer received a consumption benefit in exchange for her expenditures, and the question of whether a consumption benefit was received is central to measuring the taxpayer's income for tax purposes.

Tax Avoidance

The second reason that a taxpayer's intentions play an important role in tax law and administration is because they are used to police behavior that is undertaken to reduce tax liability inappropriately, disallowing the tax consequences of a transaction if the taxpayer lacked the proper purpose in entering into it.[32] Tax law contemplates that taxpayers will take into account the tax consequences of their actions when deciding what to do, and in fact, Congress relies on the incentives created by tax law to induce socially desirable behavior.[33] Nevertheless, common law doctrines and anti-abuse

[27] I.R.C. § 162.
[28] I.R.C. § 212.
[29] I.R.C. § 262.
[30] I.R.C. § 183.
[31] I.R.C. § 274.
[32] I.R.C. § 7701(o). I do not consider here the advisability or efficiency of anti-avoidance doctrines in general. Professor Weisbach makes a compelling case that such doctrines can be an important part of the tax system as a way of broadening the base and reducing the elasticity of taxable income. David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88 (2002).
[33] Consider, for example, the production tax credit provided by I.R.C. § 45, the ability to expense certain investments provided by I.R.C. § 179, the empowerment zone credit of I.R.C. § 1396, or the first-time homebuyer credit in I.R.C. § 36.

provisions in the Code and regulations disallow the tax consequences that would otherwise flow from a transaction if the taxpayer was *too* motivated by those tax consequences in pursuing the transaction and the tax benefits were not intended by Congress to be an inducement to the activity. Specifically, transactions that lack a business purpose altogether, or which have as a principal purpose the avoidance of federal income tax, may be disallowed.

Such intent-based tests are controversial, both because they seem to raise seemingly intractable line-drawing problems between good tax-motivated behavior and bad tax-motivated behavior, and because of problems of administration and fairness. Famously, Justice Sutherland wrote for the Court in *Gregory v. Helvering* that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[34] On the administration of intent-based tests, one scholar argues that, in light of the difficulty of proving intent: "if only a taxpayer's admission will compel a finding of tax motive, the denial of tax benefits on the basis of motive in effect imposes a tax on candor."[35]

Despite these misgivings, intent-based tests play an important role in limiting the excesses of tax-motivated behavior.[36] In light of the legal

[34] Gregory v. Helvering, 293 U.S. 465 (1935). In his dissent in *Comm'r v. Newman*, Learned Hand wrote: "[o]ver and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." Comm'r v. Newman, 159 F.2d 848 (1947).

[35] Alan Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733 (1978). Gunn argues that, in fact, "the question whether particular conduct was tax-motivated should be irrelevant to the decision whether that conduct should be taxed in a certain way." *Id.* at 765.

[36] I.R.C. § 7701(o), Treas. Reg. § 1.701-2(b). One benefit of intent based tests is that they can target abusive or nuisance transactions without the complexity that can arise from a purely objective, rules-based alternative. See Bayless Manning, *Hyperlexis: Our National Disease*, 71 NW. U.L. REV. 767 (1976); Gordon D. Henderson, *Controlling Hyperlexis -- The Most Important "Law And…"*, 43 TAX LAWYER 177 (1989).

complexity that would arise from trying to account *ex ante* for all of the undesirable ways in which taxpayers might try to reduce their taxes, and the ease with which novel transactions can often be adopted by other taxpayers and spread, at great cost to the government in terms of foregone revenue, many scholars view intent-based anti-avoidance doctrines as a necessary feature of the tax system, and some argue for more widespread use.[37] Samuel Buell has made a persuasive case for intent-based tests in settings where regulated parties can avoid prohibited conduct with minor deviations in their behavior. Tax is just such a setting. Buell argues that it is often appropriate to supplement a rules-based framework with doctrines that deal with evaders by reference to their intentions.[38]

Defining the Taxable Unit of Analysis

A third reason to take the taxpayer's intentions into account is to help delineate the boundaries of the transaction or activity to which the tax law applies. The tax treatment of two actions, viewed as parts of a single transaction, is often different than the tax treatment of the two actions viewed separately. These inconsistencies, and the opportunities they create for tax arbitrage, have been well-explored in the context of financial derivative products, where there is a robust literature on the relative merits

[37] David Weisbach argues that the use of such tests is appropriate and "the use of motive should be expanded rather than reduced." David A. Weisbach, *Ten truths about tax shelters*, 55 TAX L. REV 215 (2001) ("there are good reasons to base anti-avoidance doctrines on motive or intent. There is a difference between somebody engaging in a transaction for purely business reasons that happens to have fantastic tax consequences and somebody entering into the transaction solely to reduce taxes. In the former case, where the taxpayer enters into the transaction for business reasons, there is no economic distortion caused by taxes-while the person pays low taxes, behavior is not distorted by this prospect. In the latter case, where the motive is taxes, behavior is distorted, and there are real economic costs. The two cases are different precisely because of mental states.")

[38] Buell, *supra* note 2.

of "integration" and "bifurcation" approaches.[39] But the importance of defining the boundaries of a transaction is not limited to financial products. For example, Section 265(a)(2) disallows any deduction otherwise allowable for "[i]nterest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt [from federal income tax]." How does the tax authority know whether indebtedness was incurred *to* (i.e., for the purpose or with the intention of) purchase or carry tax-exempt debt?

In his seminal article on mental states, Blum wrote that: "[i]n many areas of tax…we face the question whether the various moves in a series of more or less related actions are to be viewed separately or are to be classified only after being consolidated in some fashion,"[40] and asked rhetorically "[w]hat tests can we use to make this determination, other than an inquiry into the thoughts of the actor, or of a hypothetical average actor, before and during the time the various steps were taken?"[41]

One could imagine grounding the inquiry in something other than the taxpayer's intentions depending on the policy reason for consolidating actions for tax purposes. But often the reason is the concern that taxpayers will take advantage of inconsistencies in the tax code to create arbitrage opportunities, and in that case it is hard to imagine that the test for which transactions should be consolidated should turn on how they were viewed by the taxpayer herself.

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[39] See, e.g., Yoram Keinan *Book Tax Conformity for Financial Instruments*, 6 FLA. TAX REV. 676 (2004); Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319 (1991); Randal K.C. Kau, *Carving Up Assets and Liabilities—Integration or Bifurcation of Financial Products*, 68 TAXES 1003 (1990); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243 (1992); Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX. L. REV. 571 (1995); David A. Weisbach, *Tax Responses to Financial Contract Innovation*, 50 TAX. L. REV. 491 (1995).

[40] Blum, *supra* note 17 at 529-530.

[41] *Id.* at 530.

2. Optimal Taxation

As we saw in Section 1, private information of the taxpayer must be considered under the federal income tax to (1) reach the consumption component of income, (2) discourage excessive tax avoidance activity, and (3) identify which actions should be consolidated or aggregated to determine the taxable unit. Most of the scholarly literature on the role of intentions in tax is focused on these norms.[42] But the place of intent in normative theories of taxation has been underexplored. This is somewhat surprising in light of the fact that the motives of taxpayers are at the core of the optimal tax problem.

The optimal taxation literature in economics takes up the question of how to maximize social welfare, measured as the (weighted) sum across all individuals of their well-being or utility, through a system of tax and transfer, recognizing that the system of taxes and transfers will generally change the costs and benefits of engaging in various activities and cause people to make choices that they would otherwise not make.[43] The distortionary effect of taxation on these individual choices is the cost of redistributing resources from individuals who have a greater ability to pay taxes to those who have a lesser ability to pay. The core optimal tax problem is how to assign taxes and transfers in a way that reflects unobservable differences in individuals' ability to pay while minimizing the

[42] See, e.g., Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365 (1988); Walter J. Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967); John. H. Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAW. 275 (1969).

[43] See, e.g., Louis Kaplow, *An Optimal Tax System*, 32 FISCAL STUD. 415 (2011); ROBIN BROADWAY, FROM OPTIMAL TAX THEORY TO TAX POLICY (2012).

distortionary effect that those taxes have on behavior.[44]

The key to solving the optimal tax problem is to assign tax liabilities in a way that does not change the prices that individuals face, and hence does not change the incentives that taxpayers have to work, invest, consume, or structure their affairs to avoid taxes. A head tax, for example, would have no distortionary effect on decisions because no decision can change someone's tax liability. However, such a tax would not permit redistribution on the basis of ability to pay because everyone pays the same amount in tax. But a tax that is based on other immutable taxpayer characteristics that are correlated with individuals' ability to earn income could facilitate redistribution without distorting choices.[45] These immutable characteristics are known in the literature as "tags." Much recent tax scholarship in law and economics has focused on how to make taxes dependent on tags of ability to pay.[46]

Intent-based taxes can complement taxes based on tags in helping to solve the optimal tax problem. For example, consider an individual deciding whether to invest in a taxable or a tax-exempt bond.[47] Suppose that, for this investor, the taxable bond has a higher pre-tax yield but a lower after tax-

[44] N. Gregory Mankiw et al., *Optimal Taxation in Theory and Practice*, 23 J. ECON. PERSP. 147, 150 (2009) ("In the Mirrlees framework, the optimal tax problem becomes a game of imperfect information between taxpayers and the social planner. The planner would like to tax those of high ability and give transfers to those of low ability, but the social planner needs to make sure that the tax system does not induce those of high ability to feign being of low ability.")

[45] There may be reasons external to redistributive efficiency that we may not want to base taxation on immutable characteristics. See Matthew C. Weinzierl, *Why Do We Distribute So Much But Tag So Little? The Principle of Equal Sacrifice and Optimal Taxation*, NBER Working Paper No. 18045 at 29 (2012), http://www.nber.org/papers/w18045.pdf ("I show that optimal policy can simultaneously match three aspects of the U.S. tax code that are incompatible in conventional theory: it rejects the use of height, gender, and race as tags; it accepts the use of blindness as a tag; and it provides substantial redistribution through progressive income taxes.")

[46] See, e.g., Helmuth Cremer, *Tagging and Income Taxation: Theory and an Application*, 2 AM. ECON. J.: ECON. POL'Y 31 (2010)

[47] I.R.C. § 103.

yield than the tax-exempt bond. The statutory exclusion from gross income for interest from tax-exempt bonds distorts the investor's choice from the taxable to the tax-exempt bond *because* the interest on the latter is exempt from tax.[48] Suppose, instead of the language that currently appears in Section 103 of the Code, that the exclusion provided that: "Gross income does not include interest on any State or local bond unless the bond is held just because the interest would otherwise be excluded from gross income." If income from the bond is excluded only if it is not the reason that the investor holds the bond, then the exclusion can never distort her choices.[49]

A simple numerical example demonstrates the benefits of intent-based taxes. Suppose that society consists of two individuals, Andrea and Brian, each of whom can perform some task that will earn a single payment. Andrea is a talented worker who would earn $5 in wages for completing the task but who also values her free time at $4.50. Brian is less talented and would earn $1 from performing the task, but he values his free time at $2. The most efficient allocation of resources is for Andrea to perform the task and for Brian to relax. This would result in aggregate economic output of $7: $5 for Andrea and $2 for Brian.

Suppose that we wanted to raise revenue from Andrea and Brian on the basis of their ability to pay and then share the pool of revenue equally among them; the sole purpose of the plan is redistribution. One choice might be a 30% tax on wages. Faced with an after-tax wage of $3.50, Andrea would not perform the task, we would have no tax revenue, and aggregate output would be only $6.50: $4.50 worth of leisure for Andrea

[48] Of course, in this case, Congress *intended* to distort the allocation of capital towards certain state and local debt.

[49] Alex Raskolnikov calls tax-motivated actions "irredeemably inefficient acts." He argues that "once a decision maker concludes that a particular tax-minimizing transaction violates the legislature's objective, taxpayer motivation becomes doctrinally important." Alex Raskolnikov, *Irredeemably Inefficient Acts: A Threat to Markets, Firms, and the Fisc*, 102 GEO L.J. 1133 (2013).

and $2 worth of leisure for Brian.

Alternatively, if we knew that Andrea was more productive than Brian, or had an observable tag for her ability, we could simply impose a $1.50 tax on Andrea and contribute that amount to the common pool. Faced with a choice between working (which will net her $3.50, after-tax) or relaxing (which will provide her with $3 in value from the $4.50 worth of leisure less the $1.50 tax), Andrea will work. After all is said and done and her $1.50 in taxes is redistributed 50/50 between her and Brian, Andrea will have $4.25 and Brian will have $2.75. Aggregate economic output is $7, the most efficient outcome, but we have achieved some redistribution from Andrea to Brian.

Intent-based taxes can achieve the same outcome. Suppose that wages are taxed at 30% as before but that the value of leisure only goes untaxed if the avoidance of tax was not the reason that the taxpayer chose leisure over work. Since Brian will choose leisure over work whether work is taxed or not, then he pays no tax and chooses leisure, which is worth $2 to him. Since Andrea would choose work but for the fact her wages would be taxed, she will be taxed if she chooses leisure and therefore faces a choice between working and earning an after-tax wage of $3.50, or relaxing and getting $3.00 of benefit, after-tax. Andrea will choose to work, and aggregate output will be $7: $4.25 for Andrea and $2.75 for Brian.

The same outcome could also be achieved if we taxed Andrea on her income earning potential, regardless of whether she exercised that potential by actually earning a cash income or not. The notion of taxing someone on their income-earning potential, rather than her actual income, raises a number of theoretical concerns relating to fairness and liberty,[50] in addition to the readily apparent practical problem of trying to identify with any

[50] See Lawrence Zelenak, *Taxing Endowment*, 55 DUKE L.J. 1145, 1156-61 (2006).

reasonable degree of precision an individual's income earning potential.[51] However, the idea has a long intellectual pedigree and from a utilitarian or, more generally, welfarist perspective it has very desirable theoretical properties.[52] This example shows that we can achieve some of the same results as a tax on income-earning potential by making tax liability depend on the individual's intent to avoid taxes. Although intent-based taxes have their own problems of administrability, they don't generally raise the same concerns about individual liberty as endowment taxes and, because tax avoidance motives already have a patina of impropriety, they may not face the same opposition.

Thus, one way to achieve the "first-best" solution to the optimal tax problem would be to directly observe a taxpayer's ability to pay the income tax. A second way to achieve the same would be to directly observe the reasons why taxpayers make the decisions they do. Neither is perfectly achievable, because a taxpayer's intentions and her ability to pay a tax are unobservable. But the two approaches share the same challenges – the unobservability of the taxpayer characteristics on which we would like to condition tax liability – and could potentially complement each other in helping to design a more efficient tax regime.

B. Where Tax Law Depends on Private Information

In this subpart I describe the role that intentions play in resolving four classic tax problems: (1) determining whether a transfer is a gift, (2)

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[51] See Id. at 1149-53.

[52] For thorough analysis of endowment taxation and the literature, see *Id.* See also Ilan Benshalom & Kendra Stead, *Values and (Market) Valuations: A Critique of the Endowment Tax Cons*ensus, 104 NW. U.L. REV. 1511 (2010); Daniel Shaviro, *Endowment and Inequality*, in TAX JUSTICE: THE ONGOING DEBATE 123 (Joseph J. Thorndike & Dennis J. Ventry Jr. eds., 2002); Kirk J. Stark, *Enslaving the Beachcomber: Some Thoughts on the Liberty Objection to Endowment Taxation*, 18 CANADIAN J.L. & JURIS. 47 (2005).

determining whether an expense is business or personal in nature, (3) determining whether an action had a business purpose or was motivated only by tax benefits, and (4) determining whether the "step transaction" doctrine applies.

1. Gifts

Although transfers of money or property between business associates are likely to be deductible by the transferor and included in income by the recipient, gifts are neither deductible by the giver not included in the recipient's income.[53] If the transferee has a higher tax rate than the transferor, then it will be beneficial for the parties to characterize the transfer as a gift, rather than as a business expense.[54] Whether a transfer is a gift depends on the motivation of the transferor. If the transfer is made from "detached and disinterested generosity"[55] of the transferor and "out of affection, respect, admiration, charity or like impulses"[56] then it is a gift, and "[w]hat controls is the intention with which payment, however voluntary, has been made."[57]

In light of the complexity of human motivations, and the fact that relationships between people often involve a web of perceived rights, obligations, and sentiments that traverse both business and personal interactions, it can be very difficult to determine "out of" what motivations

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[53] I.R.C. § 102.

[54] As Blum noted about gifts, "[i]f differentiations are based on the reason (or reasons) why a transferor gave something of value to the taxpayer…the classification cannot avoid inquiring into state of mind." Blum, *supra* note 17 at 543. There is a per se rule for gifts from employers to employees in Section 102(c). However, Treas Regs. § 1.101-1(f)(2) allows that an employer can nevertheless make a gift to her employee if that employee is the natural object of her affection.

[55] Comm'r v. Duberstein, *supra* note 4; Comm'r v. LoBue, 351 U.S. 243 (1956).

[56] Robertson v. United States, 343 U.S. 711 (1952).

[57] Comm'r v. Duberstein, *supra* note 4. (quoting Bogardus v. Comm'r, 302 U.S. 34, 45 n.8 (1937) (Brandeis, J., dissenting)).

a transfer was made; the transferor may have multiple purposes in making a transfer. Unfortunately, courts have concluded that little can be said, in general, about whether a transfer is a gift, concluding that the decision "must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case."[58]

2. Hobby Losses

Expenses incurred for the production of income or for the taxpayer's trade or business are deductible, whereas personal expenses are not.[59] Classifying an expense as one or the other can be very difficult as well as artificial in cases where an expense is incurred for multiple purposes. The "hobby loss" rules in Section 183 of the Code focus squarely on activities that have mixed business and personal aspects, and grapple with the issue of whether an activity was entered into *for profit* or not.[60] Section 183 applies to activities not engaged in for profit, and disallows any deductions attributable to that activity to the extent that they exceed the gross income from that activity.[61] By contrast, if deductions exceed gross income from an activity that the taxpayer has entered into for profit, or which constitutes the taxpayer's trade or business, then those deductions can reduce the taxpayer's taxable income from other sources.

The test of whether an activity is entered into for profit is the taxpayer's

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[58] *Id.*

[59] I.R.C. §§ 212, 162, 262.

[60] As one scholar puts it, "The fundamental problem with respect to [achieving fairness and efficiency] is that the activity may provide both pecuniary and nonpecuniary returns while only the pecuniary return is taxable." Allan J. Samansky, *Hobby Loss or Deductible Loss: An Intractable Problem*, 34 U. FLA. L. REV. 46 (1981).

[61] I.R.C. § 183(b)(2).

subjective intent,[62] and does not depend on whether the taxpayer's expectation of profit is reasonable. The history of courts applying Section 183 is a series of fact-specific inquiries into activities that have the potential to generate income but that may also constitute recreation for the taxpayer, such as breeding horses, writing or photography.[63] Because each case ends up turning on the facts peculiar to it, there is very little precedential value in prior decisions, and little guidance that they provide for other taxpayers.[64]

3. Tax Avoidance

Transactions that lack a "business purpose" and are entered into solely for tax benefits may be disregarded under current law. For example, Section 7701(o) provides that a transaction will be treated as having economic substance, and its tax consequences will therefore be upheld, if it meaningfully changes the taxpayer's economic position (apart from federal income tax effects) and the taxpayer "has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[65]

The focus in economic substance inquiries is often on the potential for pre-tax profit, although Daniel Shaviro notes that prominent practitioners have criticized the emphasis on pre-tax profit because a small amount of pre-tax profit is easily generated by taxpayers who are motivated primarily

[62] Metz v. Comm'r, 2015 TC Memo 54 (2015); Skeen v. Comm'r, 864 F.2d 93 (1989).

[63] See Estate of Stuller v. U.S., 811 F.3d 890 (7th Cir. 2016 (horse-breeding); Whitecavage v. Comm'r, T.C. Memo 2008-203 (dog-breeding).

[64] Samansky, *supra* note 60 at 51 ("The issue of whether losses should not be deductible because incurred in a hobby or other personal activity has been extensively litigated. No leading cases, however, provide guidance for all others. Each case is decided on its facts, and no case is strong precedent for another.")

[65] Section 7701(o). This is true in the case of any transaction "to which the economic substance doctrine applies."

by the tax benefits of a transaction.[66] David Weisbach notes that:

> [t]his sort of advice, to adjust transactions to make them slightly more 'real' is the daily fare of transactional tax lawyers. They advise clients on how long they must wait before a transaction is 'old and cold' for corporate tax purposes. They advise clients how much risk must be inserted into a costless collar to avoid the constructive sale rules. They ensure that investors have just enough equity stake to be considered partners, that financial instruments have enough debt features to be classified as debt, and so on.[67]

In light of how easy it is to manipulate the objective features of a transaction to make it more "real," it is perhaps unsurprising that the subjective, intent-based, element of the economic substance doctrine was incorporated when it was codified in Section 7701(o).

Intent-based anti-avoidance rules also appear in the Treasury Regulations. For example, consider the partnership anti-abuse regulation in Treas. Regs. Section 1.701-2. The discretion that partnerships have in deciding how to allocate income among their partners creates significant opportunities for tax planning and avoidance. In order to help mitigate the use of partnerships to facilitate inappropriate tax avoidance, the Treasury Department promulgated a general anti-abuse rule. Section 1.701-2(a) states that subchapter K (pertaining to partnerships) requires a business purpose

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[66] Daniel Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, July TAX NOTES (2000) ("So long as one dumps enough net capital into an arbitrarily defined "transaction" for a sufficient period to earn an interest-like return, one presumably is bound to produce an overall pre-tax profit no matter what.")

[67] Weisbach, *supra* note 37 at 238-239.

for any transaction or series of transactions entered into by a partnership.[68] Moreover, the regulations provide that:

> [I]f a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.[69]

The regulations go on to describe some of the facts and circumstances that are deemed relevant, including whether the partners' aggregate tax liability is "substantially less" than if they conducted the activities directly or if purportedly separate transactions that are "designed to achieve a particular end result are integrated and treated as steps in a single transaction."[70] These facts and circumstances are not, however, an exhaustive list of those that will be considered and the inquiry into whether a partnership was formed with the principal purpose of reducing taxes in a manner inconsistent with the intent of the tax law is an open-ended one.

4. Defining a "Transaction"

[68] Treas. Reg. § 1.701-2(a)(1) ("The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.")
[69] Treas. Reg. § 1.701-2(a).
[70] Treas. Reg. § 1.701-2(c).

Taxpayer intentions also matter is in determining whether a series of actions will be aggregated for the purposes of the tax analysis. The "step transaction" doctrine is the doctrine that courts use to determine whether to perform this aggregation. In determining whether to apply the step transaction doctrine, courts apply one of three fact-intensive tests: (i) the 'binding commitment' test, (ii) the 'end result' test, and (iii) the 'mutual interdependence' test.[71] The binding commitment test depends on whether there is a binding agreement to enter into the subsequent steps when the first step is entered into.[72] The 'end result' test steps together transactions that were "intended from the outset to be taken for the purpose of reaching the ultimate result."[73] And the 'mutual interdependence' test aggregates transactions that would not individually have a business or economic justification.[74]

Courts have been explicit about the role of intent in the end result test, which applies when a series of transactions "are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result."[75] Which facts and circumstances do courts use to infer intent? In applying the end result test, courts look to the documentation of the transactions, including emails and board minutes and side agreements. Typically, the test is satisfied when there are explicit mentions in the record of the parties' intentions,[76] or admission by the parties.[77]

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[71] Yoram Keinan, *Rethinking the Judicial Step Transaction Principle and a Proposal for Codification*, 22 AKRON TAX. J. 45, 49 (2007) (citing True v. U.S., 190 F.3d 1165, 1174-75 (10th Cir. 1999)).

[72] Id. at 64-67.

[73] King Enterprises, Inc. v. United States, 418 F.2d 511 (1969).

[74] Id.

[75] Penrod v. Comm'r, 88 T.C. 1415, 1429 (1987).

[76] Security Indus. Ins. Co. v. United States, 702 F.2d 1234 (1983) (explicit mention of intention to merge companies in confirmation); King Enterprises, Inc. v. United States, *supra* note 72.; JE Seagram Corp. v. Comm'r, 104 TC 75 (1995). ("The purpose of the [JES Tender] Offer is to acquire a majority of the issued and outstanding Shares and thereby control [Conoco]").

In contrast, one might view the binding commitment and mutual interdependence tests as simply describing the method by which courts arrive at inferences about the taxpayer's intentions. For example, a taxpayer who has documented that she will only enter into a transaction A if she also consummates transactions B and C has provided clear contemporaneous evidence that she views these three transactions as deriving their value, at least in part, from the other transactions and that she is motivated by their joint outcome. Similarly, it is reasonable to infer that when a transaction does not appear to have an economic justification independent from another transaction that the taxpayer has entered into, or that the taxpayer could not enter into it without the effects of another transaction (such as the financing it provides), then the taxpayer must have viewed the transactions collectively. Thus, the taxpayer's intentions are central in the application of the step transaction doctrine in any of its three forms.

C. The Costs of Misleading

The law places the taxpayers' intentions at the center of whether a transfer is a gift, whether an expense is deductible, whether the tax consequences of a transaction will be disallowed, and what the boundaries of a transaction are. Of course, courts cannot observe intentions, so they must infer those intentions from the facts and circumstances surrounding the taxpayer's actions.[78] Because of this, as a practical matter, laws that depend on intentions are in effect dependent on the observable external

[77] See, e.g., True v. US, 190 F.3d 1165 (1999); H.J. Heinz Co & Subsidiaries v. United States, 76 Fed. Cl. 570, 589 (2007).

[78] David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860 (1999); Blum, *supra* note 17 at 504 note 44 ("Any state of mind test is likely to develop a set of subordinate rules of thumb which make explicit the external factors that are relevant in ascertaining state of mind. These make possible some consistency of treatment.")

facts and circumstances from which inferences are drawn.[79] Naturally, it is in the economic interest of taxpayers to disguise or misrepresent their intentions to obtain favorable treatment under a facts and circumstance test, and they are assisted in this endeavor by both professional tax advisors and other, like-minded, taxpayers who are facing the same tax issues .[80]

For example, people with a shared interest in an activity with aspects of both personal pleasure as well as profit-making potential, such as artists or musicians, share information about how to conduct their activity so that it is less likely to be subject to the hobby loss limitations in Section 183. They do this by conducting their activities to pass for someone motivated primarily by profit, such as by maintaining accounting records, creating a website on which they sell their goods and services, open separate bank

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[79] Blum, *supra* note 17 at 544 ("But while there is a difference between tests based on states of mind and tests based on external factors, we have seen that results under the two types of tests are generally not very far apart. Whenever state of mind is relevant, the most important operational question usually concerns the weight that is to be attached to various external factors.")

[80] http://www.forbes.com/sites/anthonynitti/2014/10/08/a-tale-of-two-activities-how-to-beat-the-hobby-loss-rules/#3d17613a72a9 (providing guidance for "what we should do -- and, much more importantly, *not* do -- to beat the hobby loss rules.") Richard J. Kovach, *Bright Lines, Facts and Circumstances Tests, and Complexity in Federal Taxation*, 46 SYRACUSE L. REV 1287 (1995) ("A construction contractor might wish to avoid employment taxes respecting a crew of carpenters. A competent tax advisor can explain how the contractor and carpenters should alter their behavior to maximize chances for attaining the desired tax result. The objective of such behavior modification would be the creation of a set of facts and circumstances totally in support of the proposition that the carpenters are not employees. Unfortunately, at least some of the proposed changes in behavior are likely to cause great inconvenience to the contractor and carpenters.") In 2009 the IRS issued a manual for field agents to use when auditing hobby losses. Forbes advised that the new hobby loss manual for field agents was itself a blueprint for how to arrange one's affairs to generate a favorable tax conclusion. Tax advisors play a role too, giving advice about how to "help avoid IRS disallowance of losses…[or] insure a solid case for the Tax Court." Burns and Groomer, supra note 168 at 206. See also http://www.forbes.com/2010/01/08/irs-tax-audit-hobby-losses-personal-finance-robert-wood.html ("Will the IRS pay for your hobby? The short answer is: No. But the more nuanced answer is: "Yes, Uncle Sam will sometimes subsidize your hobby." If, that is, you make it into enough of a real business.") Among the suggestions includes manipulating when expenses are incurred to try and gain the presumption.

accounts, and so on.[81] Taxpayers are also often advised to manipulate the timing of their expenses and income from an activity across tax years so that they are able to demonstrate a positive income in three of the previous five years; doing this creates a favorable presumption under the hobby loss rules about whether the activity is engaged in for profit.[82]

The decoration of transactions with ancillary activities to disguise the taxpayer's true intentions is not only a waste of resources from society's perspective, but it encourages taxpayers to be dishonest. One prominent practitioner worries about intent-based tests for just this reason, arguing that "such doctrines have induced taxpayers and their counsel to take elaborate steps to clothe tax-motivated schemes in the dress of business purpose, thus introducing a significant lack of candor and forthrightness into the relationship between taxpayers and the government."[83] He also writes:

> the importance of business purpose under the tax common law has…clearly had significant deleterious collateral effects with respect to tax administration. Taxpayers and their advisors will often go to considerable lengths to dress up tax-motivated transactions to support a finding of business purpose. To a significant extent, this massaging of 'business purpose' has corrupted the function of professional opinions. Moreover, self-serving testimony as to business purpose has often actually been

[81] See Susan Lee, *Hobby Loss: Can Artists Take Losses on Their Tax Returns*?, FREELANCETAXATION.COM, https://www.freelancetaxation.com/hobby-loss-can-artists-take-losses-on-their-tax-returns (last visited Feb. 10, 2017); Martin M. Shenkman, *Avoid the Hobby Loss Deduction Limits*, WORKERS ON WHEELS: WORK FOR RVERS AND CAMPERS, http://www.work-for-rvers-and-campers.com/hobby-loss.html (last visited Feb. 10, 2017).

[82] I.R.C. § 183(d).

[83] Dana L. Trier, *Beyond the Smell Test: The Role of Substantive Anti-Avoidance Rules in Addressing the Corporate Tax Shelter Problem 52nd Annual Federal Tax Conference*, 78 TAXES - TAX MAG. 62, 65 (2000).

presented by taxpayers in court.[84]

This dishonesty is especially worrisome because it is easy for taxpayers to engage in it without openly acknowledging the artifice. Whereas inventing a business expense whole-cloth leaves little room for self-deception that what one is doing is wrong, it is comparatively easy to convince oneself that among the various motives one has for entering into a transaction is some business purpose, and that adopting the factors that one knows will persuade a court is simply a cost of revealing to the court something that might be true in any event (or so the taxpayer can tell herself).[85]

Thus, the problems with facts and circumstances tests are threefold. They invite taxpayers to decorate their activities with the indicia of tax favored intentions, which (1) is socially wasteful, (2) cause the intent-based test to be overinclusive and therefore excessively costly, in revenue terms, and (3) encourages dishonesty.[86] Any proposal to improve facts and circumstances tests must deal with these three problems. In Part III, I make a proposal that is rooted in economic models of asymmetric information that addresses these three concerns. To implement my proposal, however, it is first helpful to formalize in an economic model taxpayers' intentions regarding gifts, the consumption/business expense dichotomy, tax

[84] *Id.* at 83.

[85] As Blum notes, Blum notes that: "[t]he process [of inference from external events to intentions] is obviously full of pitfalls. Not only may recordations and recollections be corrupted by possible tax consequences, but the very thoughts that did enter the actor's consciousness may have been spawned or refined by an awareness of tax considerations." Blum, *supra* note 17 at 498.

[86] In analyzing intent-based tests, Buell notes other ways that regulated parties may manipulate evidence about their intentions: "Actors may not leave sufficient evidence to permit conclusions ex post about what they were thinking at the time of their conduct. To the extent actors are aware that legal inquiry focuses on mental state, actors may learn to thwart the anti-evasion doctrine itself by taking steps to reduce the availability of such evidence." Buell, *supra* note 2 at 664.

avoidance, and their perception of how the various actions they undertake are integrated. In the next Part, I describe how that can be done.

II. ECONOMICS OF INTENTIONS AND OTHER PRIVATE INFORMATION

My approach to structuring facts and circumstances inquiries is an economic one, and although the basic logic does not require any particular formalisms to understand, conducting a thorough analysis of how to apply it to a particular law requires being explicit and precise about exactly how the normatively relevant private information affects the decisions made by taxpayers. In this Part, I show how private information about taxpayers' intentions can easily be incorporated into economic models of taxpayers' preferences so that the legal rules applicable to gifts, hobby losses, tax avoidance, and the step transaction doctrine can be analyzed within a formal economic framework.

A. Intentions in Economics

Economic analysis of the law has largely neglected the role of intentions as a precondition for liability. Instead, it has focused on the connection between actions and consequences, rather than the connection from actions *and* states of mind to consequences.[87] The limited scholarship about the

[87] See, e,g, Cass and Hylton, *supra* note 22 at 660 ("Economic analyses of law have tended to ignore intent doctrines, focusing on rules framed in terms of the actor's conduct.") But see Keith N. Hylton, *The theory of penalties and the economics of criminal law*, 1 REV. L. & ECON. 175 (2005); Assaf Hamdani, *Mens Rea and the Cost of Ignorance*, VA. L. REV. 415 (2007); Jeffrey S. Parker, *The Economics of Mens Rea*, 79 VA. L. REV. 741 (1993); Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232 (1985). Gary Becker suggests that intent may be relevant as a proxy for the elasticity of supply of crimes with respect to punishment. Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POLIT. ECON. 169 (1968).

economics of intent has tended to employ informal reasoning.[88] One explanation for the prevalence of informal reasoning about mens rea in a literature that otherwise makes extensive use of economic models is that the economics literature, from which much tax law scholarship borrows, does not provide a way of formalizing intentions. At one time this was true, but it is no longer the case. There have been significant theoretical advances in modeling the variety of motives that people have, advances that are grounded in a robust empirical literature. Among other things, these models allow individuals to be motivated by status, a desire to conform,[89] or emotions like disappointment,[90] regret,[91] and conforming to identity categories.[92] The theoretical apparatus exists, it has just been underutilized. Why? The complexity of the models is one explanation, but another is the perception that these models, and behavioral economics in general, raises special methodological problems that are best avoided.[93]

Economic models of individual decision making assume that individuals are consequentialist. That is, individuals evaluate their choices by the states of the world that those choices bring about. The task of the economist is to specify which features of the state of the world are relevant to the individual in making her choice, since not all of them will be. Those features that are relevant are the domain over which her preferences are defined. If those

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[88] A good example of incorporating social preferences into a welfare analysis of gift and estate tax policy is provided by Kaplow, who asserts that "understanding donor's motives is extremely important in formulating estate and gift tax policy." Louis Kaplow, *A Framework for Assessing Estate and Gift Taxation, in* RETHINKING ESTATE AND GIFT TAXATION (2011).

[89] B. Douglas Bernheim, *A theory of conformity*, J. POLIT. ECON. 841 (1994).

[90] Graham Loomes & Robert Sugden, *Disappointment and Dynamic Consistency in Choice under Uncertainty*, 53 REV. ECON. STUD. 271 (1986).

[91] Han Bleichrodt & Peter P. Wakker, *Regreat Theory: A Bold Alternative to the Alternatives*, 125 THE ECON. J. 493, 494 (2015).

[92] George A. Akerlof & Rachel E. Kranton, *Economics and Identity*, 115 Q. J. ECON. 715 (2000).

[93] In fact, as Joel Sobel shows, this is not the case. Joel Sobel, *Interdependent preferences and reciprocity*, 43 J. ECON. LIT. 392 (2005).

preferences satisfy certain properties, then they can be conveniently represented by a function that assigns a numerical value to those features: a utility function. It is conventional to assume that the individuals care primarily, often exclusively, about their material consumption in any state of the world. The primary reasons for this convention are parsimony (economic models strive to be explain as much behavior as possible with the simplest and fewest assumptions) and the psychological assumption that individuals are primarily self-interested.

The consequentialist framework of individual decision making, and the conventions that render testable models from this framework, have all been subject to criticism for being inaccurate descriptions of how human psychology works. The field of behavioral economics generally is concerned with incorporating insights from psychology to develop more accurate models of individual decision making. The branch of the literature that is relevant for incorporating intentions into economics is the research on "social preferences."[94]

Individuals frequently are motivated to take actions for reasons other than the maximization of their after-tax wealth. Models of "social preferences" retain the assumption that individuals' preferences over states of affairs depend only on the allocation of material resources in that state, but they incorporate other-regarding concerns. For example, these models may incorporate altruism, spite, and an aversion to inequality.

In light of evidence that individuals' concern for the material well-being of others may be contingent on characteristics of those other people, such as whether those other people are altruistic or spiteful, subsequent work

[94] Professor Kaplow has provided an extensive treatment of how other-regarding preferences affect optimal tax analysis, including the taxation of transfers and the taxation of the family. LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS (2011).

developed so-called “interdependent preference models.”[95] In these models, an individual’s evaluation of states of the world depends not just on the allocation of material resources, but on the personalities of other people. Thus, for example, an individual’s altruism may be limited to only those people who she believes are also altruistic. These models may appear to be a radical departure from traditional models of economic decision making, but they retain much of the basic apparatus. The literature on social preferences enriches the standard model by incorporating motivations beyond narrow self-interest, but it remains faithful to the basic framework in which individuals have preferences over states of the world and choose the actions that maximize the satisfaction of those preferences in light of their beliefs about the likelihood that particular states of the world will occur.

Another approach to modeling intentions comes from the literature on “psychological game theory.”[96] Under this approach, an individual’s intentions are inferred from her behavior, from the actions taken and the actions foregone, which means that the objectives of the actors are inseparable from the institutional context in which they interact. This is an advantage of this approach, in light of evidence that individuals care not just

[95] Faruk Gul & Wolfgang Pesendorfer, *Interdependent preference models as a theory of intentions*, 165 J. ECON. THEORY 179 (2016); David K. Levine, *Modeling altruism and spitefulness in experiments*, 1 REV. ECON. DYN. 593 (1998).

[96] George A. Akerlof & William T. Dickens, *The Economic Consequences of Cognitive Dissonance*, 72 AM. ECON. REV. 307 (1982); John Geanakoplos, David Pearce & Ennio Stacchetti, *Psychological games and sequential rationality*, 1 GAMES ECON. BEHAV. 60 (1989); Martin Dufwenberg & Georg Kirchsteiger, *A theory of sequential reciprocity*, 47 GAMES ECON. BEHAV. 268 (2004); Pierpaolo Battigalli & Martin Dufwenberg, *Dynamic psychological games*, 144 J. ECON. THEORY 1–35 (2009); Gary Charness & Martin Dufwenberg, *Promises and Partnership*, 74 ECONOMETRICA 1579–1601 (2006); Matthew Rabin, *Incorporating fairness into game theory and economics*, AM. ECON. REV. 1281–1302 (1993). I have been unable to identify any legal scholarship drawing on Rabin’s model to explain the law, perhaps due to its complexity. However, applying psychological game theory see, e.g., Peter H. Huang & Ho-Mou Wu, *Emotional responses in litigation*, 12 INT. REV. LAW ECON. 31 (1992); Peter H. Huang, *International Environmental Law and Emotional Rational Choice*, 31 J. LEG. STUD. S237 (2002).

about outcomes but also the process by which those outcomes came about.[97] This framework allows the researcher to model emotions such as surprise and disappointment that cannot be modeled within the traditional framework. On the other hand, an enormous advantage of interdependent preference models is that they preserve the separation of the individuals' preferences and the institutional context in which they make their choices, and thereby facilitate an evaluation of the institutions themselves.[98]

For this reason, in this Article I adopt the interdependent preference model. I assume that an individual has the intent to bring about a consequence if that consequence is motivationally significant for her; that is, it enters into her utility function with a positive valence. In addition to being a convenient modeling choice, this corresponds to the popular notion that something is intended if and only if it is motivationally significant.[99]

This is the same approach adopted by Steven Shavell and Louis Kaplow.[100] Shavell assumes that a party "desires" a result if it raises her utility and she "intends" a result if she desires it and acts in a way that she believes raises the probability of that result coming about.[101] Walter Blum described purpose as "an end in view, meaning anything that is regarded as

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[97] Lewinsohn-Zemir reports evidence that people evaluate outcomes after accounting for the identity of the parties involved, the process by which the outcome was arrived at, and the parties' intentions. Daphina Lewinshon-Zamir, *Taking Outcomes Seriously*, UTAH L. REV 861 (2012). Hayashi also finds that the desirability of an outcome depends on the roles played by individual agents and chance in bringing it about. A. T. Hayashi, *Occasionally Libertarian: Experimental Evidence of Self-Serving Omission Bias*, 29 J. LAW ECON. ORGAN. 711 (2013). In fact, both intentions and outcomes matter. Armin Falk, Ernst Fehr & Urs Fischbacher, *Testing theories of fairness—Intentions matter*, 62 GAMES ECON. BEHAV. 287 (2008). The notion that intentions may affect the evaluation of an outcome is related to the idea that individuals derive utility from the procedure that generated the outcome. Bruno S. Frey, Matthias Benz & Alois Stutzer, *Introducing procedural utility: Not only what, but also how matters*, 160 J. INSTITUTIONAL THEOR. ECON. JITE 377–401 (2004); B. S. Frey, *Beyond outcomes: measuring procedural utility*, 57 OXF. ECON. PAP. 90–111 (2004).

[98] Gul and Pesendorfer, *supra* note 95 at 182.

[99] Kimberly Kessler Ferzan, *Beyond Intention*, 29 CARDOZO L. REV 1147 (2007).

[100] Kaplow, *supra* note 94.

[101] Shavell, *supra* note 87.

having had an effect upon producing the decision to undertake the action being scrutinized,"[102] and the Tax Court has held that "the major quality of a 'purpose' within the framework of the statutory sections here involved is to be determined in the light of the effect which consideration of [the tax benefit]…had upon producing the decision."[103] Thus, there is enough overlap in what economists, legal scholars, and courts mean by "intend" that incorporating these considerations into an individual's utility function with a positive valence seems to be a satisfactory way of capturing this common understanding.

B. Modeling Intentions in Tax Law

In this subpart, I return to the cases of gifts, hobby losses, tax avoidance, and defining the "transaction" to demonstrate how intentions can be incorporated into simple economic models. Before doing so, however, it may be useful to establish as a baseline the traditional economic model from which these other models depart, but which remains the mainstay of law and economics analysis in the tax literature. Suppose that Andrea is a realtor who periodically receives client referrals from Brian. Andrea has accumulated wealth of $100,000 and is considering whether to spend $500 on a watch for Brian. She knows that if she buys Brian the watch then Brian will reciprocate with referrals worth $1,000 in commissions. The expense is deductible, and the commissions are taxable, at the same tax rate t.[104] We can describe Andrea's preferences and her motivations with the following utility function u_a, which reflects how well off she is if she buys the watch

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[102] Blum, *supra* note 17 at 509.

[103] Truck Terminals, Inc., 33 T.C. 876, 885 (1960), aff'd in part, rev'd in part, Truck Terminals, Inc. v. Comm'r, 314 F.2d 449 (1963).

[104] If the watch is a gift for tax purposes, then $t = 0$.

for Brian:

$$u_a = \$100{,}000 - (1-t)\$500 + (1-t)\ \$1{,}000 \qquad (1)$$

The first term is her wealth before entering into the transaction. The second term reflects the cost of the watch, assuming that the expense is deductible, and the third term reflects the after-tax income from the commissions. This representation of Andrea's preferences embeds several important assumptions. First, Andrea is assumed to care only about her own wealth.[105] Second, the only benefit that the purchase of the watch for Brian gives Andrea is the monetary return of $(1-t)\$1{,}000$. Third, Andrea values each dollar of tax deductions at the same fixed rate t, which is the same rate at which each dollar of tax costs her. Fourth, Andrea evaluates the decision to buy the watch for Brian by reference to her after-tax *wealth,* not just the incremental effect of buying the watch on her income. This can be seen by the fact that the $\$100{,}000$ enters into Andrea's utility function, even though it is not affected by her choice about whether to buy the watch. Note that Andrea's utility can be re-written as $u_a = \$100{,}000 + (1-t)\$500$. The examples that follow show how minor changes to this traditional model can be made to incorporate other features of her psychology.

1. Gifts

What are the intentions of someone who acts out of "detached and disinterested generosity" in transferring property to another person?[106]

[105] We have also assumed that the marginal utility of wealth is constant, for the sake of simplicity. If Andrea were risk-averse, her wealth level would affect her preferences.

[106] As Blum put it, the focus should be on, equivalently, whether: "What commercial and what noncommercial goals did the transferor seek to accomplish? and asking: What

Certainly, this excludes the expectation of a solely monetary return, in the form of business opportunities. Modeling this intention requires loosening the first assumption embedded in equation (1), that Andrea cares only about her own wealth. Clearly, in the case of a gift there is some sense in which it is the wellbeing of the transferee that motivates the giver, but there are multiple possibilities about how to change the function (1) to accommodate this. Perhaps the most natural way is to assume that Andrea cares directly about the utility Brian gets from the watch. We can indicate the utility that Brian gets from the watch by $u_b(watch)$ and the degree to which Andrea cares about this with the parameter θ.

$$u_a = \$100{,}000 + (1 - t)\$500 + \theta u_b(watch) \tag{2}$$

If Andrea cares about Brian then $\theta > 0$, and if she doesn't care then $\theta = 0$. We expect that θ will generally be less than 1, as Andrea is less motivated by Brian's wellbeing than by her own material well-being.

Note here that Andrea cares about Brian's wellbeing only to the extent that it is improved by her gift of the watch. Andrea doesn't care about Brian in general; she cares about the benefit Brian get as a result of her gift to him. Andrea is motivated by the "warm glow" of giving. The difference has important consequences. For warm-glow givers, public support for a charity is an imperfect substitute for gifts made by the person themselves and provides a case for subsidizing charitable giving rather than making direct government grants to charities.[107]

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emotions or thoughts connected with such goals activated him?" Blum, *supra* note 17 at 493.

[107] James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 ECON. J. 464–477 (1990).

2. Hobby Losses

Consider an alternative set of facts. Andrea buys a guitar so that she can join Brian's band. The band plays on the weekend and earns a modest income, such that Andrea will earn $\$1{,}000$ in income from the gigs she plays.[108] The central question in determining whether an individual engages in an activity *for* profit or *for* the production of income is whether she is primarily engaged in that activity for personal consumption benefit. As one scholar notes "[p]ersonal consumption, which is 'taxed' by disallowing any deduction for it, is conventionally identified by its alleged characteristic of yielding personal pleasure or utility."[109] Thus, a natural way to incorporate the intent to obtain personal consumption benefits is to include them in Andrea's utility function. Let $v(music)$ be the personal consumption benefits that Andrea gets from playing her guitar. Again the degree to which she enjoys this benefit is captured by the parameter θ:

$$u_b = \$100{,}000 + (1 - t)\$500 + \theta v(music) \qquad (3)$$

In general, θ could be more or less than 1 and will depend on whether Andrea happens to actually derive personal enjoyment from playing the music. If she does, then θ will be positive, and if not then $\theta = 0$. Of course, it could even be the case that she actively dislikes playing in the band and the income is compensation for this discomfort, in which case θ could even

[108] Mixed income-producing/personal motivations exist in a number of situations, including work. In fact, many people work for free. Steffen Rätzel, *Labour Supply, Life Satisfaction, and the (Dis)Utility of Work*, 114 SCAND. J. ECON. 1160 (2012). Education, also has mixed business and personal characteristics. Joseph M. Dodge, *Taxing Human Capital Acquisition Costs--Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927, 939 (1993). Dodge asserts that "pleasure, by itself is (properly) never sufficient to deny deductibility." *Id.* at 954.

[109] Dodge, *supra* note 108.

be negative.

3. Tax Avoidance

The third assumption of the traditional model is that all taxpayers are motivated by tax deductions valued at the same rate t. The simplification of (1) used in the previous two examples relies on this equivalence. Adapting (1) to admit the possibility that some taxpayers may be more motivated by the tax benefits of a transaction than others proceeds in two steps. Because losses are not refundable, in general the tax benefit of a deduction is less than the cost of an inclusion. A taxpayer who does not have sufficient taxable income will carry the loss forward and the benefit of the deduction will be discounted by the time value of money. Thus, taxpayers with different amounts of current and expected future taxable income from other sources will value a loss differently.

Let $T(\$500)$ be the tax benefit of spending $500 on the watch. Since Andrea may be limited in her ability to currently use an expense and may instead have to use it in the future, and therefore discount the tax savings she gets from using it, the additional tax benefit of each additional dollar deduction will be no more, and perhaps less than the dollar before. One can think of this as the diminishing marginal tax benefit of a dollar of deductions, analogous to the diminishing marginal utility of wealth assumption that is conventionally made in law and economics.[110] On the other hand each additional dollar of taxable income generates a taxed cost of t, so the tax cost of earning $1,000 is fixed at $t\$1{,}000$. The net tax benefit of incurring the $500 expense is the difference between $T(\$500)$

[110] See C. Edwin Baker, *Utility and Rights: Two Justifications for State Action Increasing Utility*, 84 YALE L.J. 39, 41 (1974); Pietro Trimarchi, Transfers, Uncertainty and the Cost of Disruption, 23 INT'L REV. L. & ECON. 49, 49-50 (2003).

and $t\$1{,}000$, and different taxpayers may be motivated by the tax consequences to different degrees. We can denote the degree of tax motivation with the parameter θ, so that Andrea's utility can be written as follows:

$$u_a = \$100{,}000 + \$500 + \overbrace{\theta(T(\$500) - t\$1{,}000)}^{Net\ tax\ benefit} \qquad (4)$$

The terms in parentheses represent the net tax benefit of the transaction. There is abundant evidence from the economics literature that taxpayers differ in how motivated they are by taxes and tax benefits. Different taxpayers have different sensitivities to tax avoidance arising from differences in tax salience, taxpayers' awareness or sophistication as well as differences in their general aversion to taxes.[111] These differences can easily be captured in a simple model that allows us to analyze how tax rules affect taxpayers differently according to their tax sensitivity.

4. Defining a "Transaction"

The final assumption in the traditional model is that taxpayers maximize their after-tax wealth. More generally, they evaluate the actions available to them in light of all of their circumstances and all of the other actions that they take. Contrary to this assumption, economists have long recognized

[111] Raj Chetty, Adam Looney & Kory Kroft, *Salience and Taxation: Theory and Evidence*, 99 AM. ECON. REV. 1145–1177 (2009); Andrew T. Hayashi, *The Legal Salience of Taxation*, 81 U. CHI. L. REV. 1443 (2014).; Wojciech Kopczuk, *Redistribution when avoidance behavior is heterogeneous*, 81 J. PUBLIC ECON. 51–71 (2001); Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689 (2009). The parameter on tax benefits could depend on the level of tax avoidance behavior. Both internal feelings of guilt and external informal sanctions may depend on the local level of tax avoidance. Patricia Funk, *Governmental Action, Social Norms, and Criminal Behavior*, 161 J. INSTITUTIONAL THEOR. ECON. JITE 522 (2005).

that "[a] mass of evidence, and the ineluctable logic of choice in a complicated world, suggest that people 'narrowly bracket': a decision maker who faces multiple decisions tends to choose an option in each case without full regard to the other decisions and circumstances that she faces."[112] The inability to integrate the effects of multiple choices can easily lead to suboptimal decisions. Suppose that you were presented with the following two decisions, knowing that you would reap the consequences of both choices.[113]

Decision (1). Choose between:

A. a sure gain of $240

B. 25% chance to gain $1000, and 75% chance to gain nothing

Decision (2). Choose between:

C. a sure loss of $750

D. 75% chance to lose $1000, and 25% chance to lose nothing

In an experimental study of these choices, 60% of subjects in an experiment chose A from decision (1) and chose D from decision (2). Suppose that instead of making decisions (1) and (2) you were offered the following decision:

Decision (3). Choose between:

E. 25% chance to win $240, and 75% chance to lose $760.

F. 25% chance to win $250, and 75% chance to lose $750.

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[112] Matthew Rabin & Georg Weizsäcker, *Narrow Bracketing and Dominated Choices*, 99 AM. ECON. REV. 1508 (2009). See also Daniel Read, George Loewenstein & Matthew Rabin, *Choice Bracketing*, 19 J. RISK UNCERTAIN. 171–197.

[113] Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453 (1981).

Offered these choices, all subjects in the experimental study chose option F over option E. This certainly appears rational, since option F is just option E with the addition of $10. But note that, taken together, options A and D yield a 75% chance to lose $760 and a 25% chance to gain $240 (the $240 sure gain from option A can just be added to the potential outcomes of option D). This is exactly the same as option E. And also, taken together, option B and option C yield a 25% chance to gain $250 and a 75% chance to lose $750. This is exactly the same as option F. Thus, although no one chose option E, a significant majority chose that option when it was the result of two simpler choices.

This example illustrates that individuals cannot always easily integrate the effects of their choices, even when there are only two choices with fairly simple outcomes. The tax law, of course, creates an enormously complicated environment in which the joint effect of multiple transactions can be hard to anticipate. Tax laws can interact in all kinds of ways that may be overlooked by taxpayers, particularly those who are not well advised. As a consequence, some taxpayers may tend to evaluate the tax consequences of their activities on a transaction-by-transaction basis.[114] Suppose that Andrea can decide to earn additional (untaxed, for the sake of simplicity only) income of $100, but that her ability to deduct the cost of the watch for Brian is reduced by her total income, so that each dollar of deduction is worth $\frac{t}{1+100}$. Now Andrea has two decisions to make: how much income to earn and whether to incur the cost of the watch. We can represent the utility that Andrea expects to get from earning $100 and

[114] The salience of a tax or tax benefit may also vary by taxpayer. Hayashi, *supra* note 130. Jacob Goldin & Tatiana Homonoff, *Smoke Gets in Your Eyes: Cigarette Tax Salience and Regressivity*, 5 AM. ECON. J. ECON. POLICY 302–336 (2013).

buying the watch as:[115]

$$u_b = \$100{,}100 - 500\left(1 - \frac{t}{1+\theta 100}\right) + 1000(1-t) \qquad (5)$$

The first term simply captures her pre-tax wealth. The second term reflects the after-tax cost of purchasing the watch, and the third term is the after-tax income from the commissions. Now, θ reflects how well Andrea takes into account the effect of earning income on her tax deduction. If $\theta = 1$, her decision about whether to earn the additional income will fully take into account the effect that earning that income has on deductibility of the cost of the watch, and she will decide whether or not to buy the watch in light of her decision about whether to earn the additional income. In fact, she will make both of these choices simultaneously, to ensure that he gets the best overall result. However, if $\theta = 0$ then Andrea will make the choices as though they were totally unrelated. For any value of θ between 0 and 1 she will consider, imperfectly, the effect that earning income has on the deductibility of the watch.

III. A PRINCIPLE FOR CHOOSING FACTS AND CIRCUMSTANCES

So far, we have seen that tax consequences often turn on private information of the taxpayer, and that a variety of kinds of private information, including intentions, can be incorporated into economic models of taxpayer decision making and therefore analyzed using those tools. In particular, incorporating private information into richer models of

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[115] Rabin and Weizsäcker, *supra* note 131; Nicholas Barberis & Ming Huang, *Preferences with frames: A new utility specification that allows for the framing of risks*, 33 J. ECON. DYN. CONTROL 1555 (2009); Nicholas Barberis, Ming Huang & Richard H. Thaler, *Individual Preferences, Monetary Gambles, and Stock Market Participation: A Case for Narrow Framing*, 96 AM. ECON. REV. 1069 (2006).

individual decision making allows us to rigorously analyze how we might go about drawing inferences about that information from taxpayer behavior in facts and circumstances tests.

In this part, I set forth the first part of my proposal for structuring facts and circumstances inquiries. I propose that the facts and circumstances should be chosen according to the following "screening principle": o*nly those ways of carrying on the activity that are much less costly for taxpayers with the relevant hidden characteristics should be used in a facts and circumstances test.* Choosing facts according to this principle makes it possible to screen out those with the relevant intention or other hidden characteristic from those without.[116]

Interpreted through the lens of the economic models in Part II, the principle should be used to select features of the activity that affect taxpayers utility differently depending on their value of θ. Using this principle to identify the relevant facts and circumstances for inferring private information makes it possible to look to objective factors as a proxy without creating an incentive for taxpayers to adopt wasteful behaviors to mislead the factfinder, thereby solving the key inferential problem in making taxes depend on private information. By focusing on objective factors rather than relying on taxpayers' representations about their intentions, it also avoids the problem that intent-based taxes are viewed as a tax on candor and avoids creating a temptation for taxpayers to be dishonest or misrepresent their intentions; the framework aligns self-interest with an

[116] There are some other technical conditions that we want the screening facts to satisfy. In addition to the negative correlation between the cost of the signal and presence of the characteristic, there should be fine-grained levels in signal within appropriate cost range. Michael Spence, *Job Market Signaling*, 87 Q. J. ECON. 355, 368 (1973). This is a principle in the sense of Ehrlich and Posner, who assert that "Properly understood, 'principles' are simply the considerations that are relevant in determining the content of a rule." Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEG. STUD. 257 (1974).

honest revelation of the taxpayers' intentions.

The intuition for this principle is straightforward. If the only way to obtain favorable tax treatment for an activity is to incur some additional cost, and that cost imposes less of a burden for the person who we want to receive the treatment than the one that we don't, then the precise amount of that cost can be chosen so that only the first person will be willing to incur it to obtain the favorable tax treatment. Suppose, for example, that a company enters into a complicated financial investment. The probability that the transaction will succeed or not is private information of the company, but if it does succeed it will yield a modest profit. If it does not succeed, the transaction will generate significant tax benefits. Suppose also that the law prevents a taxpayer from obtaining those benefits if the taxpayer did not expect to make a profit. We cannot know what the taxpayer's expectation was about the likelihood of the investment succeeding, but we can reliably infer them if we can identify peripheral activities that are much more costly for a company that does not expect to earn profits to undertake than one that does expect to earn a profit.

This principle is not at all revolutionary, and in many areas of the tax law may reflect what courts are already doing. I consider this a virtue of the principle. The principle both provides a partial explanation for why judges and factfinders choose the facts that they do, and is therefore an explanation of what the law is as well as a statement of what it should be. By stating what the law is, my hope is to provide some rationalization of what appear on their face to be unstructured and unconstrained inquiries based on nothing more than the judge's idiosyncratic views and the "illimitable ocean of individual beliefs and experiences."

But the other virtue of the screening principle is that it is justified as an efficient way of sorting taxpayers on the basis of their private information, and it can provide the touchstone for which Justice Cardozo struggled in vain. By being explicit about the test that facts must satisfy in order to generate an inference to private information, my hope is that facts and circumstances inquires can be made more disciplined and taxpayers will find it harder to manipulate factfinders' inferences. My formulation also draws attention to the importance of identifying facts that differ *significantly* in cost for different taxpayers. Although courts often seem to have an unconscious sense that something like the screening principle should be guiding their inferences, placing too much reliance on factors that vary only weakly in how costly they are can induce taxpayers to engage in too much socially wasteful planning.

"Screening," as a concept, is also deeply embedded in tax law scholarship and is fundamental to optimal tax theory, the economic framework for evaluating taxes that has had such influence over the field of tax law and policy.[117] For this reason, my proposal will be familiar to tax law scholars and is closely connected to existing literature on how the creation of rules that impose different costs on different groups can induce an efficient sorting of people into those receiving favored treatment and those not.

A. Screening and Tagging

The simple idea that tax treatment should depend on differences between taxpayers that are difficult to mimic is rooted in economics

[117] Leigh Osofsky, *Who's Naughty and Who's Nice - Frictions, Screening, and Tax Law Design*, 61 BUFFALO LAW REV. 1057, 1058-1059 (2013) ("A large body of literature regarding optimal tax theory addresses screening taxpayers. At base. . . screening mechanisms in the optimal tax context track characteristics indicative of ability and impose greater costs on high ability taxpayers trying to obtain low tax rates or other benefits, in order to target the low rates or benefits more accurately to low ability taxpayers.")

research on screening and tagging.[118] The concept of screening is at the heart of the optimal taxation literature.[119] The normative aim of this approach is to tax individuals on their "ability to pay," which is an unobservable characteristic affecting the productivity of their labor efforts. We can't observe that parameter, so we tax something that is correlated with that parameter, namely, income. The problem, of course, is that individuals who have a high ability to pay may choose to earn less income, thereby mimicking those who have a lower ability to earn income and receiving a lower tax bill. The optimal tax problem, discussed in Part I.A., is how to tax more heavily those with a higher ability to earn while preventing the "high-ability" individuals from acting like they have low ability.[120]

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[118] Joseph E. Stiglitz, *The Theory of "Screening," Education, and the Distribution of Income*, 65 AM. ECON. REV. 283–300 (1975); William Vickrey, *Counterspeculation, Auctions, and Competitive Sealed Tenders*, 16 J. FINANCE 8–37 (1961); George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488–500 (1970); Jennifer F. Reinganum, *Plea Bargaining and Prosecutorial Discretion*, 78 AM. ECON. REV. 713–728 (1988). ON the related topic of "ordeals", see Albert L. Nichols & Richard J. Zeckhauser, *Targeting Transfers through Restrictions on Recipients*, 72 AM. ECON. REV. 372–377 (1982); TOMER BLUMKIN, YORAM Y. MARGALIOTH & EFRAIM SADKA, THE ROLE OF STIGMA IN THE DESIGN OF WELFARE PROGRAMS (2008), https://papers.ssrn.com/abstract=1137843 (last visited Feb 5, 2017); George A. Akerlof, *The Economics of "Tagging" as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning*, 68 AM. ECON. REV. 8–19 (1978).

[119] This approach originated in James Mirrlees' path breaking 1971 paper. J. A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175–208 (1971).

[120] Screening logic has been used to address a couple of specific problems under the income tax. Alex Raskolnikov has argued that it is possible to create two regimes for taxpayer compliance: one that resembles current law but with higher penalties for improper reporting, and another with lower penalties but in which taxpayers will have a disfavored position in litigation with the IRS over questionable transactions. Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689 (2009). Raskolnikov distinguishes between "separating" and "targeting" features of the two regimes, with the first intended to cause different types of taxpayers to sort between the regimes, and the second designed to facilitate compliance. Larry Zelenak has noted that that we should be concerned about the fairness of subjecting certain taxpayers to a tilted playing field solely to discourage other taxpayers from choosing that regime. Lawrence Zelenak, *Tax Enforcement for Gamers: High Penalties or Strict Disclosure Rules?*, 109 COLUM. L. REV. SIDEBAR 55–64 (2009). Emily Satterthwaite argues that tax

In order to assign higher tax liabilities to high-ability individuals without creating strong incentives for mimicry, we need to make taxes dependent not on choices, but on immutable characteristics, things that the taxpayers cannot themselves change (or at least not without prohibitive expense). To the extent that taxes and transfers can be made contingent on characteristics that serve as proxies for ability, they can be made more efficient. These characteristics are known as "tags."[121] One such example is the enhanced standard deduction for individuals with visual impairment.[122]

The logic of screening and tagging as applied to intent-based tests is simply that, in order to provide differential tax treatment based on intentions, the law must condition tax treatment on behavior and characteristics that are correlated with the intention that we wish to favor. For some of these behaviors, the only function they serve is to help differentiate between taxpayers based on their intentions so that taxes can be better targeted. These behaviors are known in tax law scholarship as "frictions." The idea that frictions can be an important constraint on tax planning is also a well-understood idea in the tax literature.

B. Backflips With a Twist

One way of thinking about facts that satisfy the screening principles is that they create "frictions," in form of pecuniary or other costs, on the kind of tax planning that individuals would like to engage in, with the added feature that they impose greater frictions on certain taxpayers than others.

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elections can serve as screening devices. Emily Satterthwaite, *Tax Elections as Screens*, Forthcoming QUEENS LAW J. (2016).

[121]Akerlof, supra note 149.

[122] I.R.C. § 63(f)(2). More generally, however, the federal income tax does not assign tax liabilities on the basis of immutable characteristics such as race, gender, and height, for reasons that likely have to do with fundamental notions of fairness embodied in the equal protection clause of the Federal Constitution.

Practitioners and tax scholars are well-acquainted with the role that economic risk and other frictions have on the willingness of taxpayers to undertake tax-motivated transactions. Frictions are costs of one sort or another that taxpayers must bear in order to receive favorable tax treatment for a transaction. As David Schizer has observed, frictions can arise in many ways, including differences in accounting and regulatory treatment, that discourage taxpayers from switching for tax reasons between economically equivalent transactions.[123] These costs generally require that taxpayers deviate from their most-preferred transaction. "Economic substance" approaches to deterring tax planning are focused on such frictions.[124] From an efficiency perspective, the desirability of such frictions depends on two considerations: the importance of deterring tax planning, and the effectiveness of the frictions in deterring the planning rather than simply causing taxpayers to bear unnecessary costs while still engaging in the planning.[125] The "nature" of the friction, on this account, is unimportant. As Professor Shaviro memorably puts it:

> one might as well condition favorable tax consequences on whether the taxpayer's chief financial officer can execute 20 back-somersaults in the IRS National Office at midnight on April Fool's Day, if such a requirement turns out to achieve a better ratio of successful deterrence to inducing wasteful effort in meeting

[123] David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUMBIA LAW REV. 1312 (2001). For this reason, Schizer argues that "[s]tudying frictions thus should become a priority for legal commentators." *Id.* at 1317.

[124] Shaviro says that: "If we did not use economic substance tests to challenge the reality of the cubbyholes taxpayers try to exploit, we would in effect have created a regime of pure electivity to claim whatever losses and ignore whatever gains one likes. The frictions imposed by an economic substance rule burden taxpayer electivity. If tax rules are sufficiently well-designed, they can reduce overall deadweight loss even though they induce particular taxpayers to waste even more resources." Shaviro, supra note 21 at 518.

[125] Shaviro, supra note 66.

requirements that are pointless in themselves.[126]

Of course, frictions do not affect all taxpayers equally. Leigh Osofsky has advanced our understanding of these effects and argued for the use of frictions as screening devices for tax planning.[127] Her criteria for evaluating frictions is: "First, frictions must impose greater costs on tax planners than non-planners. Second, as to tax planners, the friction must deter tax planning, rather than causing it to continue in a more wasteful fashion. Third, the benefits from the first two steps (from increased efficiency and lower tax liability for non-planners) must outweigh costs that taxpayers bear as a result of the friction."[128] As an example of good screen, Osofsky offers the wash sales rules, which she argues "principally screens among taxpayers with different motivations for selling built-in loss stock."[129] The screening principle I have set forth should select facts that satisfy the criteria for good frictions advanced by Professor Osofsky.

C. Application: Hobby Losses

In this subpart, I discuss how the screening principle can be used to tailor the facts and circumstances test for hobby losses. Distinguishing between hobbies and activities engaged in for profit has historically been difficult, particularly in the early stages of a business, when the taxpayer may be working during her free time, generating significant losses, and experimenting with ways of conducting the business that may not pan out. Taxpayers have historically taken aggressive positions to exploit this

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[126] *Id.*
[127] Osofsky, *supra* note 117.
[128] Osofsky, supra note 117 at 1059.
[129] *Id.* at 1094.

difficulty. In 2007, the Treasury Inspector General for Tax Administration published a report finding that1.5 million taxpayers with significant income from other sources reported only losses on their Schedule C in the years 2002-2005.[130] Of these taxpayers, 73 percent had tax preparation assistance.[131] These losses may have saved these taxpayers as much as $2.8 billion in taxes in Tax Year 2005.[132]

These rules are also becoming more important with the increasingly unstable nature of employment and the rising popularity of activities that people engage in to supplement their income but that may also have hobby-like characteristics.[133] For example, arts and crafts sold through websites like Etsy, and multi-level marketing schemes, are frequent targets of the hobby loss rules.[134] An example of the tax wisdom that is passed around on this point is illustrated by the following post from a multi-level marketing online discussion forum for a product called "Beachbody"

> When you're a Beachbody Coach, you have to be a product of the product. That makes your workouts, shakes, workout gear, tv to watch your workouts on, gas mileage to buy the stuff, cups to drink shakes from, workout shoes, utilities to run your business, office space, ect. [sic] tax deductible. Am I making sense yet? You don't get these kind of tax deductions when you work for someone else! As a Beachbody Coach, you can take a monthly personal expense

[130] Significant Challenges Exist in Determining Whether Taxpayers with Schedule C Losses Are Engaged in Tax Abuse, https://www.treasury.gov/tigta/auditreports/2007reports/200730173fr.html (last visited Feb 6, 2017).

[131] Id.

[132] Id.

[133] http://money.usnews.com/money/blogs/my-money/2014/03/31/does-the-irs-view-your-side-hustle-as-a-business-or-hobby

[134] http://www.forbes.com/sites/anthonynitti/2016/02/25/beachbody-coach-rodan-fields-consultant-at-tax-time-beware-the-hobby-loss-rules/#33ab16ba3c96

like Shakeology and make it a business expense that is tax deductible.

The treasury regulations promulgated under Section 183 include a list of factors to be considered in determining whether an activity was entered into for profit. These factors reflect the considerations that had been taken into account by courts before the enactment of Section 183 in 1969.[135] The Treasury Decision promulgating the regulation does not explain why these factors are sensible, and courts that have attempted to infer profit motive before and since have been similarly stingy with their reasoning as to why they look to the factors that they do.[136] Since they were promulgated, courts have looked to these regulations, paying special attention to factors that are present in the conduct of other activities that are unambiguously motivated solely by profit.[137]

To illustrate the application of the screening principle, I consider each of the factors from Treas. Regs. Section 1.183-2 in turn, and focus on the following question: can a valid inference be made from the presence of that factor to the absence of a large consumption benefit from the activity.[138] In the terms of the model from II.B.2, this is the question of whether θ is large.[139]

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[135] Jane O. Burns & S. Michael Groomer, *Effects of Section 183 on the Business/Hobby Controversy*, 58 TAXES 195 (1980) ("There is general agreement that the nine factors were extracted from prior case law.") Michelle B. O'Connor, *Primary Profit Objective Test: An Unworkable Standard, The*, 27 LOY. U. CHI. L.J. 491 (1995).

[136] Curran v. Comm'r, 29 TC Memo 696 (1970).

[137] Whitney v. Comm'r, 73 F.2d 589 (1934); Farish v. Comm'r, 103 F.2d 63 (1939); Imbesi v. Comm'r, 361 F.2d 640 (1966).

[138] I do not discuss the ninth factor in the Treasury regulations, whether there are elements of personal pleasure or recreation in the activity. This factor is in some sense at the heart of the entire inquiry. It allows that the presence of a personal motive may indicate that the activity is not engaged in for profit, but is the taxpayer need not be exclusively motivated by profit or have an intent to maximize profits.

[139] Treas Reg. § 1.183-2(a) ("deductions are not allowable under Section 162 or 212 for activities which are carried on primarily as a sport, hobby, or for recreation.")

Manner in which the taxpayer carries on the activity

The first factor from the regulations is the manner in which the activity is conducted.[140] For example, if the activity is conducted in too "casual" a manner, this may be inconsistent with how an ordinary business person would act, a fact that is part of the "data of practical human experience."[141] The regulations look to whether the activity is carried on in a "businesslike manner," meaning that books and records are maintained. Some courts have found that a separate operating name for the business is particularly important.[142] The audit technique guide distributed to revenue agents and tax compliance officers also suggests asking about whether the activity has its own bank account or website.[143]

If the activity is conducted in the way that other profitable activities of a similar nature are conducted, or the taxpayer adopts or abandons operational methods in a manner consistent with an intent to improve profitability, this factor weighs in favor of the activity being engaged in "for profit."

There are three problems with these factors. The first is the implicit assumption that taxpayers are motivated by either profit or personal enjoyment, but not both.[144] Both the person who is engaged solely for profit

[140] Treas. Reg. § 1.183-2(b)(1) (1972).

[141] Bessenyey v. Comm'r, 379 F.2d 252 (1967).

[142] Burns and Groomer, supra note 168 at 205 ("In fact, absence of an operating name has been cited as an indication that a profit motive was lacking.")

[143] https://www.irs.gov/businesses/small-businesses-self-employed/irc-183-activities-not-engaged-in-for-profit-atg

[144] As Professor Lederman notes, the dichotomy between tax avoidance motives and business purpose is a false one: "First, all profit-motivated transactions in a world with taxes are motivated by posttax profit. Second, many transactions have both tax and non-tax purposes, and it can be hard to separate and quantify them." Lederman, *supra* note 3. Nevertheless, as Justice Harlan wrote, "[f]or income tax purposes Congress has seen fit to regard an individual as having two personalities: one is a seeker of profit who can deduct

and the person who cares about profit and personal consumption benefit will have an incentive to conduct the activity in a manner that increases its profitability. The very fact that the hobby loss rules exist is premised on the fact that there are taxpayers who derive intrinsic utility from certain activities but would also like to get tax deductions for the expenses that they incur. Since deductions are valuable only for the taxes that they save, it is inconsistent to assume that these taxpayers care about dollars saved in the form of tax deductions but not about income from the activity.

The second problem is that some of these ways of carrying on the activity do not just result in increased profitability but may also yield enjoyment to the hobbyist. One scholar notes that many actions are "consistent with both pecuniary and nonpecuniary motives. Thus, a dedicated cost-conscious hobbyist as well as a determined entrepreneur might keep good records."[145] The hobbyist might also want to adopt the latest innovations and technologies solely because it increases the enjoyment of the activity.[146] Thus, even if the hobbyist is not motivated by profit, adopting these ways of conducting the business is not likely to be costlier for her than someone who is engaged in the activity solely for profit. Adopting new technologies is costly, but not *more* costly for people who aim to make a profit. That is, they are not good screening factors.

The expertise of the taxpayer or his advisors

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the expenses incurred in that search; the other is a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures." United States v. Gilmore, 372 U.S. 39 (1962).

[145]Samansky, supra note 60 at 54.

[146] For example, innovations in open source or peer-to-peer sharing software were developed by hobbyists not necessarily seeking profit. See John McGaraghan, Note, *A Modern Analytical Framework for Monopolization in Innovative Markets for Products with Network Effects*, 30 HASTINGS COMM. & ENT. L.J. 179, 187 (2007).

The regulations provide that extensive study of the business, scientific, and economic practices of the activity, or consultation with experts about these matters, may indicate that the taxpayer has a profit motive, particularly if the taxpayer adopts these practices. This factor suffers from some of the same problems as the first factor. Hobbyists and those motivated solely by profit alike might want to learn about the business, economic and scientific aspects of the activity. In fact, avid hobbyists, those who are likely to derive the *most* consumption benefit from an activity, may also be the ones who are most likely to enjoy exploring these other aspects of the activity through study or consultation with experts and other aficionados. This sort of study both generates pleasure for the hobbyist as well as income-earning potential. There is also no reason to think that engaging in this study or consultation with experts will be costlier for individuals who enjoy the activity than those who do not, meaning that they are unlikely to be useful screens.

The time and effort expended by the taxpayer in carrying on the activity, and the taxpayer's financial status

The regulations suggest that that if the taxpayer devotes a considerable amount of time and effort to an activity, particularly if she withdraws from another occupation to do so, then it is more likely that the activity is engaged in for profit.[147] This factor disadvantages taxpayers who start a business in their spare time, on weekends and evenings, as compared with taxpayers who may be able to sacrifice income from another occupation to

[147] Courts have also looked to the amount of time and labor expended by the taxpayer in engaging in an activity as proxy for profit motive because the definition of business offered by the Supreme Court in Flint specifically contained a mention of activities that consume 'time' and 'labor.' Flint v. Stone Tracy Co., 220 U.S. 107 (1911). See Wilson v. Eisner, 282 F. 38 (1922).

pursue a life of leisure.

The problem with this factor as evidence of profit motive is its reliance on the assumption that an individual who derives enjoyment from an activity cannot also be motivated to earn income from it. As between two taxpayers, both of whom enjoy receiving cash income but one of whom derives a consumption benefit from the activity and another who does not, the one who enjoys the activity will spend more time on that activity than the one who is motivated solely by profit. On its own, this factor has perverse implications, screening for the wrong kinds of taxpayers. However, if the taxpayer's efforts are interpreted in light of their financial status, more reliable inferences can be drawn.

The taxpayer's financial status rarely plays an explicitly and prominent role in hobby loss analysis,[148] but it should.[149] In general, taxpayers prefer to consume a combination of leisure and market goods purchased with cash income. An individual who is wealthier is more likely to reduce the time she spends on her other occupations and use it for leisure instead, than someone who has less wealth. Thus, a taxpayer with a significant amount of wealth who devotes a significant share of her time and efforts to an activity is more likely to be engaged in that activity for personal reasons than someone who is not wealthy but makes the same choices. It is unlikely that the taxpayers will choose to give wealth away in order to facilitate the inference that they are engaged in an activity for profit, so this factor, *in conjunction with the amount of time spent on an activity*, serves as a helpful

[148] Bishop v. Comm'r, 31 TCM 829 (1972).

[149] Professor Samansky has suggested that wealthier individuals may be more motivated by the pleasure of an activity. Samansky, supra note 60 at 51. The legislative history indicates Congress was concerned with wealthy farm hobbyists' propensity to lose money. See Tax Reform Act of 1969: Report of the Committee on Finance, United States Senate, to Accompany H.R. 13270 Together With Separate and Individual Views, S. Rep. No. 91-552, at 95 (1969) (prior "rules have allowed some high-income taxpayers who carry on limited farming activities as a sideline to obtain a substantial tax loss.")

screen.

Expectation that assets used in an activity will appreciate in value

This factor does not helpfully distinguish between individuals who do and do not received a considerable consumption benefit from the activity, because both kinds of taxpayers will be more likely to undertake an activity if there is the expectation of property appreciation. The factor does serve a useful function in making clear that the expectation of income can include *all* income, including gains from property, as well as cash flows.

Success of the taxpayer in carrying on similar activities

This factor encourages the fact finder to consider that an activity may be engaged in for profit, even if it is presently unprofitable, if the taxpayer has a history of turning around unprofitable activities. This factor is helpful in helping courts make predictions about the future profitability of the activity being scrutinized, but it falls largely outside the analysis of this paper because it arises before the taxpayer engages in the activity being scrutinized. Taxpayers are unlikely to attempt to engage in a series of activities with a pattern of early losses and subsequent income solely to create the impression that a later activity will also give rise to income.

The taxpayer's history of income and losses from the activity and the amount of occasional profits

Finally, the regulations on these factors state that losses "sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses…may be indicative that the activity is not being engaged in for profit...A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit." Drawing a connection between realized profits and losses and intentions is tricky,[150] but there is a basis for the use of actual income and losses as a factor for inferring intent.

On the one hand, if persistent losses are predictive of future losses, then the existence of persistent losses is a factor that helpfully identifies those who engage in an activity for personal benefit. Indeed, there can hardly be another explanation in such a case, since the willingness to tolerate those losses is greater for taxpayers who get a significant consumption benefit from the activity. But the inferences that can be drawn from persistent profits and losses are asymmetric. All individuals presumably enjoy profits, and so the existence of positive profits does not tell us much at all about whether the taxpayer *also* or even primarily motivated by the pleasure of the activity.

Similarly, the pattern of income and losses, whether the venture yields rare but large profits or regular, but smaller, profits does not tell us whether the taxpayer also derives a consumption benefit from the activity. This factor, like the factor on property appreciation, seems designed to disabuse courts of the notion that unless the income from the activity comes in a particular form at particular time then the activity could not be motivated by profit.

Summing up, our application of the screening principle to the factors in the hobby loss regulations paints a bit of a pessimistic picture. Many of the

[150] Courts also focus on the actual experience with profits and losses as evidence of intent, primarily because it is objective and because of what they think actual businesspersons would achieve or tolerate in the way of profits and losses. Abrams v. U.S., 449 F.2d 662 (1971); White v. Comm'r, 227 F.2d 779 (1955); Morton v. Comm'r, 174 F.2d 302 (1949); Coffey v. Comm'r, 141 F.2d 204 (1944).

factors that the Treasury Department has identified as potentially relevant are also those that are easily adopted by people who are motivated primarily by the pleasure of the activity. However, the principle also provides clarity about the usefulness of two particular factors: the financial status of the taxpayer and the amount of time devoted to the activity. Wealthier taxpayers will tend to want to spend more time in leisure, and so wealthier taxpayers who devote many hours to an activity are more likely to be engaged in that activity for pleasure than for profit.

IV. A PRINCIPLED STANDARD FOR FACTS AND CIRCUMSTANCES

In Part III, I argued that the facts and circumstances from which the law should infer private information should be those that serve as effective screens for taxpayers with the relevant information. Specifically, they should be less costly for someone with the tax-favored characteristic than someone without it. In this Part I discuss *when* the content of the tax law should incorporate facts that satisfy this screening requirement. That is, should the relevant facts be specified, ex ante, by appropriate regulatory agency, or should the facts be specified, ex post, by the courts after observing taxpayers' conduct.

I analyze this question within the rules/standards framework described by Louis Kaplow,[151] but show that the distinctive nature of laws that depend on mental states adds another dimension to Kaplow's influential analysis. My proposal for how facts and circumstances inquiries should be resolved is a standard, but it is a standard accompanied by a decision criterion for specifying its content.[152] Importantly, the choice between a rule or standard in the context of intent-based tests is a choice about which "game" is being

[151] Kaplow, *supra* note 7.
[152] *Id.*

played between the tax authority and taxpayers.[153] Strategic situations in which the regulator specifies the law in advance are known as "screening" games, while situations in which the regulated party acts first and then the regulator must interpret their actions are known as "signaling" games. Which game the regulator decides to play has important consequences.

In the final analysis, I argue that the law should neither list the facts and circumstances that are relevant, in advance, nor should it give courts unfettered discretion to identify the factors that are relevant to a mental state inference, after-the-fact. Instead, *the statute should specify the principle according to which courts will choose relevant facts and circumstances*. That principle is the screening principle.

A. Rules and Standards

Suppose that we want the legal consequence of an action to depend on private information of the actor, and that there are a collection of facts and circumstances that we know satisfy the screening condition and that we want factfinders to use in making inferences about that private information. When should the law specify those facts and circumstances? One possibility is to specify those facts and circumstances in the applicable statute or regulations. The alternative is to leave it to courts or to the agency that enforces the law to observe the regulated parties' decisions and then determine what facts to take into account and how they will be interpreted. This choice, about whether the content of the law is specified before or after the regulated parties have acted, is the choice between a rule and

[153] Although the literature on rules and standards is voluminous, the relationship between the choice between the two and hidden information has been largely unexplored. One exception is Ezra Friedman & Abraham L. Wickelgren, *A New Angle on Rules versus Standards*, AM. L. ECON. REV. (2013).

standard.[154] As Louis Kaplow puts it: "the only distinction between rules and standards is the extent to which efforts to give content to the law are undertaken before or after individuals act."[155]

Consider the rules applicable to hobby losses. Recall that Section 183 limits the deductibility of expenses in the case of an activity "not engaged in for profit." This is a standard, because all of the details about which activities, and in which manner conducted, will trigger the application of Section 183 are left for the courts or the Treasury department to work out. However, Treas. Reg. § 1.183-2 provides a non-exhaustive list of factors that are to be taken into account when determining whether an activity was engaged in for profit. The factors fill in some of the detail of how Section 183 applies and make it more rule-like. Because the factors are non-exhaustive, this places the hobby loss rules somewhere between a rule and a standard. As Kaplow notes, many legal commands occupy this space between fully specifying the conditions under which certain legal

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[154] Kaplow, *supra* note 7. This is not quite the same distinction given by Judge Posner and Isaac Ehrlich in their important article on this topic. For them, "a standard indicates the kinds of circumstances that are relevant to a decision on legality and is thus open-ended. That is, it is not a list of all the circumstances that might be relevant but is rather the criterion by which particular circumstances presented in a case are judged to be relevant or not. In an automobile collision case governed by the negligence standard these circumstances would be the speed and weight of the vehicles, their design, the time of day, the layout of the highway, the weather, and any other factors that might affect the question how the sum of the expected accident costs and the accident-avoidance costs could have been minimized." Ehrlich and Posner, supra note 116. I do not think that this is quite right. Stating the normative criteria is not the same thing is specifying the principle according to which facts will be deemed relevant, and it appears to be simple common sense that is doing that work in this example. It is left to the factfinder to know the empirical relationship between the facts and the normative criterion. I propose that factfinders be given more information about which facts are relevant. My approach will still require them to know whether a given facts has a particular screening property. Of course, another important difference is who gives content to the law. Fred Schauer argues that whether the law ultimately settles on a rule or standard may be outside of the control of the rule-maker. Frederick Schauer, *The Convergence of Rules and Standards*, 2003 N. Z. LAW REV. 303 (2003). If that is the case, then the recommendations in this paper may be moot; however, they would provide a framework for evaluating whether the equilibrium is a desirable one.

[155] Kaplow, *supra* note 7.

consequences attach (a rule) and merely "asking an adjudicator to attach whatever legal consequence seems appropriate in light of whatever norms and facts seem relevant" (the loosest kind of standard).[156]

In Kaplow's framework, the normative aim of the law may be public information but the content of the law, the assignment of legal consequences to actions and private information of the actor, is unknown to the government, courts and regulated parties alike.[157] Giving content to a law means refining that assignment process and discovering in more fine-grained detail what should be taken into account in assigning those consequences. This process of investigation is costly.[158] Since a rule has more content (i.e, more fine-grained distinctions) than a standard, the cost of promulgating a rule is greater than the cost of promulgating a standard.

Although it is less costly to promulgate a standard than a rule, a standard leaves actors with less guidance about how to comply with the law. Although those actors can learn about what the standard requires of them through hiring a lawyer and getting legal advice, this is costly. In general, it is more costly learning about what the law requires if it is formulated as a standard rather than as a rule. Rules are also more likely to induce compliant behavior than standards because actors are more likely to learn about what the law requires, and adjust their conduct accordingly.[159] Rules and standards also differ in the costs of enforcement; the cost of an

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[156] Kaplow, *supra* note 7 at 562.

[157] Here, it is worth highlighting that the uncertainty about the content of the law is exogenous. For example, the Appendix of Kaplow's 1992 paper considers the case in which an individual is strictly liable for a harm-producing activity. Neither the legislature, nor the individual nor the courts know what the magnitude of the harm is. Resolving this uncertainty will involve learning facts about the world, such as identifying the negative effects that are caused by the activity and quantifying the harm of those effects. In contrast, the law I am concerned with turn on private information of the taxpayer.

[158] *Id.* at 569 ("the ideal content of the law with respect to these issues [such as the criteria to be used in determining the assignment of liability] is not immediately apparent. Rather, some investigation and deliberation is required.")

[159] Kaplow, *supra* note 7 at 577.

enforcement proceeding is greater under a standard than a rule. In Kaplow's framework, the social objective to be pursued in choosing between a rule and a standard is the minimization of these promulgation, compliance, and enforcement costs. Because promulgation costs are incurred once, but enforcement and compliance costs are incurred each time the law applies, rules become more attractive as the frequency with which a law applies increases.

B. Choosing Between Two Games

In this subpart, I show that there is another dimension to the economic analysis of rules and standards that arises when the law depends on private information of the actor: the choice between a rule and a standard is also a choice about whether the regulator is playing a "screening game" or a "signaling game" with the regulated parties.

In a screening game, an uninformed party would like to transact with a set of individuals on terms that reflect some trait or characteristic that is private information of those individuals. If certain conditions, including the screening principle, are satisfied then the uninformed party can offer a menu of transactional terms (e.g., contracts) and the informed individuals will select different choices from the menu that reveal whether they possess that characteristic. Signaling games, by contrast, may share all of the features of a screening game but differ in that the individuals with private information about the characteristics act first, leaving the uninformed party to interpret their actions. Although the difference in who moves first may seem like an innocuous one, it can have important consequences because the potential outcomes of a signaling game may be very different than the outcomes of the screening game.

If we choose a rule for facts and circumstances tests, the tax authority and the taxpayer are playing a screening game.[160] In this game, the lawmaker uses her knowledge of differences in the preferences of taxpayers to choose a correspondence between facts and circumstances and a tax treatment; the taxpayers themselves simply respond by choosing from the alternatives in front of them. The tax authority in this game can induce taxpayers to reveal their intentions by requiring them conduct their affairs in a way that is differentially costly, depending on those intentions. In order to induce them to separate, the taxpayer with tax-favored intentions must bear some cost that the taxpayer without those intentions is unwilling to bear, even in exchange for better tax treatment.

Although it may be possible for the lawmaker to choose facts and circumstances such that it will be rational for taxpayers with the tax-favored characteristic to incur the cost to reveal that characteristics, inducing this separation of taxpayers with the characteristic and without it may not be worth the costs it imposes. In such cases, it is more efficient to provide all taxpayers with the same tax treatment regardless of whether they possess the underlying characteristic. If there are a sufficient number of taxpayers in the population who have the tax-favored characteristic, all taxpayers will be made better off if there is no effort to distinguish between them, and instead provide a tax treatment that is an average of the treatments that the two kinds of taxpayers would receive is they were to separate.[161]

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[160] A screening game with only one uninformed party is "monopolistic screening" game. The outcomes of this game differ from a screening game in which there are multiple uninformed parties competing in the marketplace. See Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976). In the Rothschild and Stiglitz screening game there can only be an equilibrium if the preferences vary sufficiently with type. John G. Riley, *Competition with Hidden Knowledge*, 93 J. POLIT. ECON. 958–976 (1985).

[161] This result may provide some justification for the 50% deductibility of meals and entertainment expenses. See Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423

If we choose a standard for the facts and circumstances test, then we leave it to the taxpayer to choose how she is going to signal to the courts the intentions she had in entering into the transaction at issue.[162] The central problem that arises in signaling games is the multiplicity of potential outcomes that arise from uncertainty about how the uninformed party will respond to an unanticipated action by the party with private information. In a signaling game, taxpayers with tax-favored intentions want to send costly signals to the tax authority that they have the tax-favored intentions.

But unlike the screening game, there are a number of possible outcomes of the signaling game in which players fully reveal their intentions, and some of them are much less desirable than others. Which if these "separating" outcomes the taxpayers arrive at depend on how judges would interpret actions that the taxpayers themselves never even take. Those beliefs may cause taxpayers to engage in much more wasteful signaling activity than should be necessary to demonstrate their hidden intentions.

The risk that judges' beliefs could induce unnecessarily wasteful signaling suggests that the law should restrict the inferences that judges draw from observing costly signals sent by parties with tax-favored intentions. Specifically, if the relevant law is a standard so that the regulator and the taxpayers are playing a signaling game, the Treasury Department should promulgate regulations restricting the inferences that judges can draw in the following way: *a taxpayer who incurs some additional cost in order to signal her intentions shall be assumed to have tax-favored intentions if a taxpayer without those intentions wouldn't incur such a cost,*

(2009) (explaining that the 50% deducibility of meals and entertainment can be attributed "to the fact that the recipients of free meals and entertainment, even in a business setting, arguably have economic income that is difficult to tax directly.")

[162] One of the first formal analysis of signaling was given by the economist Michael Spence (1973). Spence, supra note 145. The terminology is borrowed from Robert Jervis *(The Logic of Images in International Relations* (Princeton, N.J.: Princeton University Press, 1970)).

even if she were guaranteed the favorable tax treatment. Adopting this constraint on judicial inferences will ensure that taxpayers are not induced to waste too much effort signaling to the court that they have the relevant tax-favored characteristic when less costly signaling would be credible.

Like the screening game, there are conditions under which it is better not to allow taxpayers to try to distinguish themselves by persuading the factfinder that they have some normatively relevant characteristic. If the share of taxpayers without the characteristic is low enough, or if the cost of sending the signal is not much lower for the taxpayer without the characteristic than the cost to the taxpayer with the characteristic (i.e. if the signal is weak) then the law shouldn't try and distinguish between taxpayers with and without the hidden characteristic, and instead simply assign one tax treatment to everyone that does not depend on private information.

C. A Principled Standard

How does adding the additional dimension of choosing between signaling and screening games to the costs identified by Kaplow affect our analysis of rules and standards? To illustrate this, let's return to the policy goal of limiting the deductibility of hobby losses, and consider two extremes: the statutory standard and a bright-line rule.

> **Standard:** No deduction is allowable for an activity not engaged in for profit.

> **Rule:** No deduction is allowable for an activity that is conducted under circumstances $a, b, c, \ldots$..

I begin by considering the costs already identified by Kaplow before discussing the effects of choosing between a signaling and a screening game. The promulgation and enforcement costs are both lower for the case of the hobby loss rule rather than the hobby loss standard. In evaluating the compliance costs of adopting a rule or standard, it is helpful to consider three cases: when the benefit of learning about the law is (1) less than the costs of learning about how both the hobby loss rule and the hobby loss standard apply, (2) greater than the costs of learning about how both apply, and (3) greater than the costs of learning about how the hobby loss rule applies but less than the cost of learning how the standard would apply. The benefit to the taxpayer is the deductibility of her hobby/business expenses.

If the benefits to taxpayers of complying with the law are too small to justify the costs of learning about its application under a rule or a standard, taxpayers will conduct their hobbies in the same way regardless of how the law is promulgated. A standard will be preferable to a rule if the additional cost of promulgating a rule is greater than additional enforcement costs from enforcing a standard. The promulgation costs of identifying good screening facts across the entire range of hobbies seems prohibitive and a standard would be better in this case.

If individuals learn the content of the law under both a rule and a standard, then rules become more desirable. Although rules are more costly to promulgate, it is less costly for taxpayers to learn how a bright-line rule applies and less costly for courts to enforce. It is of course difficult to quantify the cost to hobbyists of learning about the standard for whether their costs will be deductible, but given the number of people who would incur this cost in this case, these aggregate costs could be quite large indeed. Thus, in this case it is likely that a rule will be preferable to a standard.

In the final case, taxpayers become informed under a rule but not under a standard, which means that their behavior will differ depending on which is enacted. In this case, a standard will be more efficient if the additional promulgation costs of a rule are greater than the net benefit to individuals of acquiring information about the law, plus the difference in enforcement costs. For the relatively low-stakes situations in which hobby losses are implicated, the benefit to taxpayers of compliance is likely to be small, and the difference in enforcement costs is ambiguous so in this case a standard is likely to be preferred over a rule.[163]

Reviewing these three cases, it is unclear whether a rule or standard is preferable. On the one hand, the costs of promulgating a rule that identified in advance all of the most helpful screening factors across all possible hobbies seems prohibitive. On the other hand, the costs to taxpayers under a standard of discovering how the standard would apply to their circumstances, given all the uncertainty of what factors a court might choose, also seems high.

One more cost must be taken into account. The facts and circumstances on which tax consequences should depend must satisfy the screening principle. But whether a particular activity is likely to have a significant personal element, and whether particular ways of carrying out that activity are likely to be differentially costly depend on how much someone enjoys the activity, may not be known by people who are sufficiently far removed, geographically and socioeconomically and culturally, from the taxpayer. Moreover, the same facts that may be good screening factors in one place may not be good screening factors in another. Implementing the screening principle is demanding on the factfinder's knowledge of the preferences of people engaged in the activity, so it is valuable for the law preserve the flexibility for factfinders to identify, based on their knowledge of local preferences, the facts that would satisfy the screening principle. This is

[163] For an analysis of bargaining in the shadow of a rule or standard, see Jason Scott Johnston, *Bargaining under Rules versus Standards*, 11 J. L. ECON. ORG. 256 (1995).

another reason in favor of a standard for facts and circumstances tests.

In light of high promulgation and compliance costs, whichever is less costly as between the rule and the standard is still likely to be very costly. Perhaps there is another option, that takes the advantages of a standard without all of the disadvantages.

> **Principled Standard:** No deduction is allowable for an activity not engaged in for profit, as determined by facts and circumstances that satisfy the screening principle.

This is a standard, because the content of the law (the factors from which intent will be inferred) are not specified in advance. The additional wrinkle that my proposal adds is that the standard specifies the principle according to which the content of the law will be chosen.[164]

This formulation has some desirable features. First, as a standard, it avoids the potentially large promulgation costs of identifying which factors should be used as screens in all of the varied circumstances in which taxpayers allege that they are engaged in a hobby for profit. Second, the costs to taxpayers of learning about which facts will be considered are relatively low because of the principle by which they are chosen. Recall that the distinguishing feature of tax laws that depend on intentions is that the content of the law depends on private information of the taxpayer: whether

[164] Kaplow asserts that "[i]deally, a standard states the normative criteria that officials will apply case-by-case to determine the law's command. The risk-utility standard for design defects in the law of products liability is a good example." The hand rule for negligence is another example of such a conventional standard. Posner and Ehrlich assert that "The term "principle" has been used in discussions of judicial decision-making to denote a maxim, sentiment, or policy informing the decisional process." Ehrlich and Posner, *supra* note 116 at 259. This is very different than what Ronald Dworkin called a principle Ronald M. Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14 (1967) ("I call a "principle" a standard that is to be observed… because it is a requirement of justice or fairness or some other dimension of morality.")

a feature of how the activity is conducted is less costly for them than someone without the tax-favored intention.[165] Taxpayers should know whether a particular way of conducting an activity or carrying out a hobby is costlier to them because the benefits that they derive from the activity. As a result, there is no need for taxpayers to conduct research to predict the content of the law, and the costs of learning about how the standard applies are lower than they would otherwise be.[166] Assuming that courts accurately apply the law and interpret the taxpayer's actions, the taxpayer can, through introspection, reason to the content of the law.

By reducing the cost of learning about the law, more taxpayers will learn what the law requires, with the result that fewer people will be deterred from engaging in side-businesses because of the possibility that they will not be able to deduct their expenses, and more people will be deterred from trying to claim deductions for hobby expenses because they will not succeed. The fact that the content of the law should largely be available through introspection also eliminates the disparities in access to the law that arise when the content of the law is determine through the costly investigation of facts about the world; it will no longer only be those who have access to legal advice who can plan in light of the law.[167]

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[165] Moreover, when individual information acquisition costs are low, Kaplow argues that self-reporting is an efficient way to implement complex rules. Louis Kaplow, *A model of the optimal complexity of legal rules*, J. L. ECON. ORG. 150 (1995). He argues that self-reporting is more efficient when private information costs are much less than the authority's costs of differentiation. *Id.* at 157. This is precisely the case here, where an individual knows how her factors will be interpreted. For a related economic analysis of rule "precision," see Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE LAW J. 65 (1983).

[166] Kaplow is skeptical that learning about the content of the law can ever be easier under a standard than a rule. Kaplow, *supra* note 7 at 597-598.

[167] I have analyzed facts and circumstances within Kaplow's framework. That analysis is focused on determining the "ideal" content of the law. This inquiry sets aside the question of how complex the law should be. As Kaplow argues, rules need not be more complex than standards. Kaplow, supra note 165 at 509. Kaplow argues that the question of how complex the law should be is largely independent of the rule/standard choice. *Id.* But

Since a principled standard is a standard, then it establishes a signaling game between the lawmaker and taxpayers; courts will still be responsible for identifying which facts and circumstances they will use to draw inferences about the taxpayers' intentions from their conduct, but they will need to choose facts that conform to the screening principle and so their discretion will be limited to consider only those facts that reliably distinguish between taxpayers with and without the tax-favored characteristics. Since taxpayers know that any signals that they try and send to the court about their intentions will be subject to this test, they will not engage in socially wasteful activities that do nothing to credibly convey that they are entitled to the tax treatment they seek. And, so long as judicial inferences are also subject to the additional guidance discussed in Part IV.B, then taxpayers will not feel compelled to engage in unnecessarily costly signaling either, and taxpayers can be expected to converge on the most efficient outcome of the game.

CONCLUSION

I have argued that the law should articulate a principle according to which facts and circumstances inquiries into taxpayers' intentions should be conducted. That principle is the screening principle: the facts from which inferences about intentions should be made should be only those that are much less costly for taxpayers with tax-favored hidden characteristic than taxpayers without that characteristic. I have shown that formal economic analysis of taxpayers' intentions can be done using innovations from behavioral economics, which offer a richer model of individual motivations than the traditional model. Finally, considering laws that depend on

see Weisbach, supra note 83 at 872 (arguing that the optimal complexity of tax rules is greater than the optimal complexity of tax standards.)

intentions and other private information adds an important nuance to the debate between rules and standards: the choice between the two is also a choice for the regulator between playing a screening or signaling game with the regulated parties, the difference between which should be incorporated into an analysis of the choice. In many cases, the best way to implement a law may be neither as a rule nor as a standard, but instead as a principled standard.

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